

# Blue Ribbon Commission on Tax Reform

## Issue Briefing Documents

October 18, 2012

## **EXECUTIVE SUMMARY AND FOREWORD**

This packet of documents was compiled for the purpose of providing additional briefing materials regarding reform options that were in some manner previously introduced to the Governor's Blue Ribbon Tax Force for Tax Reform (hereafter, "Commission"). Through the first ten sessions, the Commission has received a prolific panorama of reform ideas from various stake holders. Several of these proposals were introduced during one of the six regional meetings that were convened across the Commonwealth in order to gain input from citizens in each congressional district. The Commission was indeed thankful and attentive to the input made by each speaker.

The enclosed information is intended to aid the process of honing the broad universe of suggestions into a more prioritized subset of recommendations. As the refinement of recommendations takes shape, staff to the Commission will continue to provide more specific information on policies with the greatest level of interest.

Information for each proposal profiled in this briefing includes a summary of the proposed change to the tax code or structure, background information to give context to the proposal, comparative information about how other states treat the issue, an estimate of the fiscal impact of the proposal, and an assessment of how the proposal impacts each of the five principles of the Commission: fairness, competitiveness, elasticity, adequacy, and simplicity and compliance.

With respect to the fiscal impact analysis provided herein, several reminders are appropriate. When possible, all fiscal impacts are computed using existing state data sources. In other cases, however, sufficient data has not been identified to give specific rigor to the analytical scoring process. If the state does not impose taxes on a good or service, then the amount of the untaxed activity is typically unknown. Staff members attached to the Commission are accustomed to using alternative approaches when the situation dictates, but in many cases the estimates derived from secondary or even tertiary data are harder to compute and less precise.

A second challenge to providing accurate fiscal impacts involves the difference between a conceptual or academic proposal versus scoring based on a specific bill draft. Many of the proposals made do not provide the level of specificity required to make a precise fiscal impact estimate. Effective dates, tax rates, definitions, and other details of a proposal have a significant impact on the fiscal analysis. For example, effective dates for a new tax proposal often prohibit 100% collection of revenues until the change is fully implemented. Corporation tax estimates often have this problem since the Commonwealth permits corporations to file based on a calendar year or a fiscal year. While many smaller business entities use the calendar year accounting period, larger companies often have accounting systems based on a fiscal year. The fiscal impact estimates included herein should be used as general ranges in instances where the specific proposal is not precise.

A third consideration regarding scoring involves the dichotomy of static versus dynamic scoring. Traditionally all tax policy reviews are done in a "static" scoring structure. Static scoring makes no attempt to predict how the State economy, as a whole, will respond to the new tax changes. For example, the imposition of a sales tax on some services may be expected to affect the underlying provision of these services – thereby implicitly altering levels of employment and personal income for business producing the newly-taxed services. Only dynamic scoring models would attempt to quantify the precise secondary and tertiary interrelations. While dynamic impacts are often considered in the demonstration of the merits of a proposal, only static scoring is used to estimate the direct budgetary impact of the proposals in this analysis. This approach is consistent with the fiscal impact analysis completed for legislative proposals that impact state revenues.

A final challenge to the scoring process involves the interaction between or among multiple tax options. This problem is also quite prevalent in corporation taxes. For example, single factor apportionment is listed as one option to amend our existing tax code. Also listed is a proposal to implement mandatory combined reporting. The score of the combination of these proposals will not be the sum total of each disparate fiscal impact. When computing the effect of any one single proposal assumes that all other factors are held constant (*ceteris paribus*) during the scoring of each proposal.

For the same reason just stated, readers of this report should not attempt to add all fiscal impacts reported herein to arrive at an aggregate score. Such an attempt would be both misleading and inaccurate. As aforementioned, there will be definite interactions among proposed options that would make the aggregation process contraindicated. If a complete set of recommendations is presented, staff can begin quantifying the interactions that one policy may impart on the scoring of other policies.

As in the consultant's report that was distributed on September 19<sup>th</sup>, 2012, this briefing document includes qualitative analysis on the effects each policy change would have on the five criteria for optimal taxation. See the example below.

Score on tax reform principles				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	N

N – denotes that the policy change would be “neutral” with regard to that particular goal of taxation.

“+” – denotes that the policy change would enhance that particular goal of taxation.

“-” – denotes that the policy change would detract from that particular goal of taxation.

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## INDIVIDUAL INCOME TAXES

### Proposal # 1: Add additional tax rates for higher income individuals on the income tax

#### Background information:

- The income tax was first levied in Kentucky on January 1, 1936. The tax rate was on a graduated scale from 2% to the highest 5% for all income in excess of \$5,000. In 1950, the General Assembly increased the income tax rate to help finance poor school districts. The new top rate was 6% on income over \$8,000.
- Rates did not change again until 2005 when the rate for income over \$8,000 but less than \$75,000 was lowered to 5.8%. Top rate over \$75,000 was 6%.
- Due to the presence of local occupational license taxes in Kentucky, rates of income taxation in Kentucky are considered middle to slightly high already
- It should be noted that the state income tax is the primary mechanism whereby progressivity can be added to the overall tax structure that is somewhat regressive in the current form.
- Since the onset of the last recession, at least 12 states have increased the top marginal income tax rate or enacted surcharges in order to increase the income tax.
- In 2009 alone, nine states altered their income tax policies in order to increase revenues. Eight of these increases entailed adding new tax brackets for high-income earners or increasing the top marginal income tax rate. North Carolina increased income taxes by adding a surcharge of 2% and 3% on earners with more than \$60,000 and \$150,000 in income, respectively. 2010 was, in many ways, a repeat of 2009, but on a smaller scale. Oregon and Ohio enacted major increases in the income tax. Oregon created an 11% tax bracket for residents with incomes exceeding \$250,000 and Ohio has postponed a planned reduction in their income tax rate for 1 year. Just recently, Illinois enacted current-year increases on income taxes while Minnesota has also proposed raising that top marginal rate and imposing a surcharge on high income earners.

**Other states:** For the 2012 tax year, the surrounding states rates are as follows: Illinois' tax rate is 5% of federal AGI with modifications, regardless of filing status; Indiana's tax rate is 3.4% of AGI, regardless of filing status; Missouri's tax rates are 1.5% to 6%, with income over \$9,000 taxed at 6%; Ohio's tax rates are .587% through 5.925%, with income over 208,500 taxed at 5.925%; Virginia's tax rates are 2% to 5.75%, with income over \$17,000 taxed at 5.75%; and West Virginia's tax rates are 3% to 6.5%, with income over \$60,000 taxed at 6.5%.

**Groups positively and negatively impacted:** As with most tax increases, the groups facing higher taxes would be negatively impacted; therefore, individuals with incomes exceeding the highest marginal threshold would be negatively impact. Positive impacts would be recipients of the additional General Fund dollars. Support would also be expected from any group advocating for progressive income taxes in the hopes that low-income tax relief would be the beneficiary of higher marginal rates at the top of the distribution.

**Revenue Score:** Revenue scores would clearly depend on the specific elements of each proposal. Several bills were introduced in recent sessions of the Kentucky General Assembly. Selected scores are as follows:

- **Raise the marginal rate for income over \$100,000.** Currently income between \$8,000 and \$75,000 is taxed at 5.8% and all income over \$75,000 has a marginal tax rate of 6%. All taxable income above \$100,000 would have a new tax rate. Here are the fiscal impacts:

For taxable income > 100k	Year 1 impact	Year 2 impact
6.1%	\$12.2 million	\$12.8 million
6.2%	\$24.5 million	\$25.6 million
6.5%	\$61.1 million	\$63.9 million
Each additional 0.10%	\$12.2 million	\$12.8 million

- **Eliminate the 5.8% rate bracket** so that all income above \$8,000 would be fixed at 6%. Impact \$74.7 million in first full year.
- **Raise the rate on the top income earners.** For example, increase individual income tax rates for higher incomes by taxing income between \$75,000 and \$90,000 at 7%, and by taxing income over \$90,000 at 8%.
  - **Fiscal Impact.** Increasing income tax rates for tax years beginning on or after January 1, 2013 would result in an estimated \$87.1 million of additional revenue in FY 2013, \$236.4 million in FY 2011, and \$246.3 million in FY 2014. Employers should increase amounts withheld from employees effective for wages paid on and after January 1, 2013, and individuals who make declaration payments would be expected to increase their payments effective for the April 2013 payment.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	N

## Proposal # 2: Change the reference to the Federal Code from December 31, 2006 to December 31, 2012

*Note:* This is a proposal from both the Consultants to the Commission and the Department of Revenue.

**Background information:** An Internal Revenue Code (IRC) reference date update from 12/31/06 to 12/31/12 is needed to simplify Kentucky's income tax forms and to improve voluntary compliance by taxpayers. As a general rule, optimal tax policy should include segments of simplicity. Updating the Kentucky income tax reference date would certainly bring more uniformity, which should in turn lead to lower preparation cost for taxpayers and fewer instances of errors in calculations.

**Other states:** Kentucky's IRC reference date of 12/31/06 is the oldest used by any state, other than New Hampshire, which is 12/31/00. The reference dates for surrounding states are as follows: Illinois (IRC as currently amended); Indiana (IRC as of 01/01/11); Missouri (IRC as currently amended); Ohio (CAT – IRC as currently amended); Tennessee (Federal taxable income as currently defined by IRC); Virginia (IRC as of 12/31/11); and West Virginia (IRC in effect after 12/31/10 and prior to 01/01/12).

**Groups positively and negatively impacted:** Positively impacted would include CPA's, enrolled agents, tax software providers and taxpayers that would benefit greatly from the simplicity of fewer federal and state income tax differences. No group appears to be negatively impacted by a code update.

**Revenue Score:** Negative \$15 million initially, but the fiscal impact turns positive after about four years. Staff is currently trying to further disaggregate the fiscal impact; disaggregation of the total impact would enable the BRTF to explore partial code updates.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	+	N	+

### Proposal # 3: Create a tax credit for families that homeschool

**Background information:** A tax credit for homeschooling is a new concept and previously has not been introduced in the Kentucky General Assembly.

**Other states:** Illinois has an education tax credit equal to 25% of the amount in excess of \$250 for tuition, book fees and lab fees for a student, but not to exceed \$500 annually. Under Illinois law, homeschooled students have the same legal status as private school students; therefore, the cost of books and book fees would qualify for the credit.

Louisiana allows a deduction of 50% of any educational expenses not to exceed \$5,000 per child. Educational expenses are defined to include amounts expended for textbooks and curricula necessary for the home-schooling of each child.

Iowa and Minnesota have education tax credit laws for tuition and textbooks of each student attending an elementary or secondary school which is accredited. Since home schooling does not constitute a school that is accredited, no credit is available.

**Groups positively and negatively impacted:** Groups positively impacted - taxpayers that homeschool their children would benefit from this tax credit. Negatively impacted – taxpayers and education groups opposed to homeschooling would not favor this tax credit. Groups and entities that rely on the General Fund, including schools, would be negatively impacted.

**Revenue Score:** General Fund receipts will decrease each year by the amount of the tax credits claimed by taxpayers. The fiscal impact will be greatly impacted by whether or not a cap on the credit is provided.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	-

## Proposal # 4: Eliminate or reduce the income tax

### Background information:

- Income taxes were first imposed in 1936.
- Imposed withholding requirement in 1954.
- Adopted federal definition of taxable income in 1954.
- Rates were changed in 1960.
- The tax reform efforts in 2005 marked the first alterations in the rate of taxation since 1960.
- The individual income tax is the single largest source of General Fund revenue, topping \$3.5 billion in FY12.

**Groups positively and negatively impacted:** Groups positively impacted include virtually all taxpayers. The proposal would also help efforts for job creation and employment retention. Groups negatively impacted would be any entity that is detrimentally impacted by the precipitous loss in General Fund appropriations – or – taxpayers that would face higher rates in the remaining revenue sources to make up the lost General Fund dollars.

**Other States:** Alaska, Florida, Nevada, New Hampshire, South Dakota, Tennessee, Texas, Washington and Wyoming do not have an income tax.

**Revenue Score:** Depending on the choice to lower rates or eliminate the tax altogether, the revenue loss would be potentially profound.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	+

## Proposal # 5: Eliminate state income taxes for anyone not required to file a federal form

**Background information:** As a general rule, a taxpayer in 2011 did not have a federal filing requirement if the taxpayer was: (i) Single and under 65 with gross income under \$9,500; (ii) Single and 65 or older with gross income under \$10,950; (iii) Married filing jointly and both spouses under 65 with gross income under \$19,000; (iv) Married filing jointly and one spouse 65 or older with gross income under \$20,150; (v) Married filing jointly and both spouses 65 or older with gross income under \$21,300; (vi) Married filing separately regardless of age with gross income under \$3,700; (vii) Head of household and under 65 with gross income under \$12,200; (viii) Head of household and 65 or older with gross income under \$13,650; (ix) Qualifying widower under 65 with gross income under \$15,300; or (x) Qualifying widower and 65 or older with gross income under \$16,450.

However, other situations require a taxpayer to file a federal return for such items as special taxes, HSA distributions, earnings from self-employment, etc. In addition, taxpayers file federal returns to apply for refunds, to claim earned income credits and to carry forward net operating losses and tax credits.

Currently, few taxpayers owe Kentucky income tax if they are not required to file a federal tax return because of the family size tax credit as provided by KRS 141.066. However, due to the different filing statuses and statutory adjustments, the number of taxpayers currently paying Kentucky income tax but not required to file a federal return is indeterminable.

**Other states:** Surrounding states that have an individual income tax use the federal adjusted gross income figure to begin the taxable income computation. These states have statutory adjustments similar to Kentucky. However, none of the surrounding states exempt taxpayers from individual tax if taxpayers are not required to file a federal return.

**Groups positively and negatively impacted:** Positively impacted - taxpayers who have no federal filing requirement. Negatively impacted - the Department of Revenue. Implementation of this proposal would create a compliance challenge. For the Department of Revenue to make an accurate determination of whether or not a taxpayer has a federal income tax filing requirement, a pro forma federal tax return may be needed.

**Revenue Score:** Based on 2010 return data, approximately 71,000 Kentucky individual income tax returns were received from taxpayers that did not file a federal return.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	-	-	+

## Proposal # 6: Enact a state Earned Income Tax Credit

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “If the Commission wants to consider reducing the burden on lower income households, a *State Earned Income Tax Credit (EITC)* is one option. The *EITC*, unlike welfare and other means-test transfer programs should not adversely affect taxpayer behavior, in this case the incentives to work. While Kentucky could devise their own plan, we recommend that they follow the examples of Illinois and Indiana and “piggyback” on the federal *EITC* by offering a refundable credit that is a percentage of the federal *EITC*. A credit that is 6% of the federal credit would provide a maximum tax credit of about \$300 for a single or married household with two children. If a piggyback option is chosen, then the following attributions of the federal credit would flow-through to Kentucky:

- The federal EITC is a tax credit extended to low-wage workers.
- The federal EITC was enacted in 1975 and made permanent law in 1978
- The tax filer must be working and earning wages in order to qualify
- The credit benefits families with children the most, and the value of the credit varies depending upon family size and income level
- For tax year 2011 the maximum benefit levels were as follows:
  - \$5,112 for a family with two children with incomes from \$12,750 to \$21,750 (or \$16,700 if single)
  - \$3,094 for a family with one child with incomes from \$9,100 to \$21,800 (or \$16,700 if single)
  - \$464 for a married couple with no children and incomes from \$6,050 to \$7,600 (or \$12,700 if single)

Finally, it should be noted that this option, like the others, should be considered in conjunction with other options. The *EITC* might be a particularly attractive option if expansions to the general sales tax, particularly the taxation of in-home food, are adopted that increase the regressivity of that tax.”

Taxpayers may claim the **full value** of most tax credits only if their tax liability meets or exceeds the value of the credit. Stated another way, most tax credits cannot reduce a person’s tax bill below zero. Three tax credits-the earned income tax credit (EITC), the child tax credit (CTC), and the small Health Coverage Tax Credit (HCTC)-do not face that limitation; they are termed refundable because they can generate cash refunds that exceed the taxpayer’s tax liability. Like the federal government, states have few refundable tax credits. However, fourteen states-Colorado, Illinois, Indiana, Kansas, Massachusetts, Minnesota, Nebraska, New Jersey, New York, Oklahoma, Oregon, Rhode Island, Vermont, and Wisconsin-and the District of Columbia do provide a refundable EITC. Part of Maryland’s EITC is refundable and part is not. Four states-Delaware, Iowa, Maine, and Virginia-have a nonrefundable EITC.

Proponents of refundable credits argue that only by making credits refundable can the tax code effectively carry out desired social policy. Particularly in the cases of the EITC, precisely those low-income households most in need of assistance would be denied the benefit of the credits if they were not refundable. Furthermore, allowing credits only against income tax liability ignores the fact that most low-income families also incur payroll taxes.

Opponents of refundable credits raise four objections: that the tax code should not redistribute income; that the government should not use the tax code to carry out social policies; that everyone should pay some tax as a responsibility of citizenship; and that refundable credits increase administrative and compliance costs and encourage fraud and abuse.

Pros:

- Adds progressivity (very few options in other taxes)
- Ability to tie to earned income
- Cheaper than bracket changes
- Supporters would be advocates for low-income households

Cons:

- Unintended consequences (Not all filers with low Kentucky income are “poor”)
- Does not help the middle class
- Redistribution arguably a federal tax responsibility

**Other states:** Surrounding states’ earned income tax credits

- Indiana – State EITC is 9% of federal EITC
- Illinois - State EITC is 5% of federal EITC, increasing to 10% over the next three tax years
- Virginia – State EITC is 20% of federal EITC, but is non-refundable

**Groups positively and negatively impacted:**

Since this proposal would add progressivity to the tax code, this proposal would be beneficial to low-income workers.

**Revenue Score:** -\$45.0 million, assuming a low income credit at 5 percent of the Federal Credit

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N or +	+	-	-	-

## Proposal # 7: Implement a tax deduction for 529 college savings plan contributions

**Background information:** A 529 Plan is an education savings plan operated by a state or educational institution designed to help families set aside funds for future college costs. It is named after Section 529 of the Internal Revenue Code which created these types of savings plans in 1996.

529 Plans can be used to meet costs of qualified colleges nationwide. In most plans, your choice of school is not affected by the state your 529 savings plan is from. The Kentucky Education Savings Plan Trust (KESPT) is a college savings plan organized under Section 529 of the U.S Internal Revenue Code, and is administered by the Kentucky Higher Education Assistance Authority (KHEAA). Earnings from KESPT accounts are not subject to federal or state income taxes, if withdrawals are used for qualified higher education expenses. Additional federal tax benefits may accrue to account owners, since contributions may qualify for an annual federal gift tax exclusion. Many states offer a state tax deduction for contributions made to an approved 529 plan in their state. For example, Illinois offers a deduction in taxable income for up to \$10,000 per year for an individual and \$20,000 per year for those filing jointly when residents contribute to an Illinois 529 plan.

However, some states offer a state tax deduction for contributions by residents to any approved 529 plan, not just those sponsored by their state of residence.. For example, Missouri offers up to \$8,000 per year for an individual and \$16,000 for those filing jointly when residents contribute to any 529 plan. A Missouri resident utilizing a Virginia 529 plan would qualify for the tax deduction from taxable income.

Both approaches have been proposed in the Commonwealth in the past. House Bill 263 of the 2008 Regular Session proposed excluding \$5,000 per year for individuals and \$10,000 per year for those filing jointly. Based on historical contributions to the KESPT, the bill was estimated to have a fiscal impact of reducing state revenues by approximately \$420,000 per year.

In 2009, House Bill 488 proposed allowing a credit against Kentucky income taxes of 20% (with a maximum of \$1,000) of the amount contributed to any qualified 529 plan. This proposal was estimated to have a negative fiscal impact of approximately \$14 million per year.

**Other states:** From FinAid.org: “Many states give the account owner a full or partial state income tax deductions for their contributions to the state's section 529 plans. So far a total of 34 states and the District of Columbia offer such a deduction.”

**Groups positively and negatively impacted:** Kentucky families saving for college would be the primary beneficiaries of any proposal to allow a tax deduction or credit for qualified contributions to a 529 college savings plan.

**Revenue Score:** -\$14 million per year

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	N	-

## Proposal # 8: Limit itemized deductions

**Background information:** Under current law, there are a number of allowable itemized deductions:

- Medical expenses, to the extent that the expenses exceed 7.5% of the taxpayer's AGI. (e.g., a taxpayer with an AGI of \$20,000 and medical expenses of \$5,000 would be eligible to deduct \$3,500 of their medical expenses ( $20,000 \times .075 = 1,500$ ;  $5,000 - 1,500 = 3,500$ )) The 7.5% floor means that most taxpayers are unable to take advantage of the medical expense deduction. Allowable medical expenses include:
  - Capital expenditures that are advised by a physician, where the facility is used primarily by the patient alone and the expense is reasonable (e.g. a swimming pool for someone with degenerative spinal disorder, an elevator for someone with heart disease)
  - Payments to doctors, dentists, surgeons, chiropractors, psychologists, counselors, physical therapists, osteopaths, podiatrists, home health care nurses, cost of care for chronic cognitive impairment
  - Premiums for medical insurance (but not if paid by another, or with pre-tax money)
  - Premiums for qualifying long-term-care insurance, depending on the taxpayer's age
  - Payments for prescription drugs and insulin
  - Payments for devices needed to treat or compensate for a medical condition (crutches, wheelchairs, prescription eyeglasses, hearing aids)
  - Mileage for travel to and from doctors and medical treatment
  - Necessary travel expenses
  - Non-deductible medical expenses include:
    - Over-the-counter medications
    - Health club memberships (to improve general health & fitness)
    - Cosmetic surgery (except to restore normal appearance after an injury or to treat a genetic deformity)
- State and local taxes paid, including:
  - Income taxes (or, alternatively, state and local general sales taxes)
  - Vehicle registration license fee
  - Property taxes (assessed by reference to the value of the property)
  - but not including:
    - Use taxes
    - Excise taxes
    - Fines or penalties
- Mortgage interest expense on debt incurred in connection with up to two homes, subject to limits (up to \$1,000,000 in purchase debt, or \$100,000 in home equity loans)
  - also, points paid to discount the interest rate on up to two homes; points paid upon acquisition are immediately deductible, but points paid on a refinance must be amortized (deducted in equal parts over the lifetime of the loan)
  - also private mortgage insurance premiums through 2010
- Investment interest, up to the amount of income reported from investments (the balance is deferred until more investment income is declared)
- Charitable contributions to allowable recipients; this deduction is limited to either 30% or 50% of AGI, depending on the characterization of the recipient. Donations can be made as money, or in the form of goods. The value of donated services cannot be deducted as a contribution. Reasonable expenses necessary to provide donated services can, however, be deducted (such as mileage, special uniforms, or meals). Non-cash donations valued at more than \$500 require special substantiation on a separate form. Non-cash donations are deductible at the lesser of the donor's cost or the current fair market value,

unless the non-cash donation has been held for greater than a year (Long term), in which case it can be deducted at fair market value.

- Eligible recipients for charitable contributions include:
  - Churches, synagogues, mosques, other houses of worship
  - Federal, state, or local government entities
  - Fraternal or veterans' organizations
- Non-eligible recipients include:
  - Individuals
  - Political campaigns or political action committees (PACs)
- Casualty and theft losses, to the extent that they exceed 10% of the taxpayer's AGI (in aggregate), and \$100 (per event, \$500 starting tax year 2009)
- Gambling losses, but only to the extent of gambling income (For example, a person who wins \$1,000 in various gambling activities during the tax year and loses \$800 in other gambling activities can deduct the \$800 in losses, resulting in net gambling income of \$200. By contrast, a person who wins \$3,000 in various gambling activities during the year and loses \$3,500 in other gambling activities in that year can deduct only \$3,000 of the losses against the \$3,000 in income, resulting in a break-even gambling activity for tax purposes for that year -- with no deduction for the remaining \$500 excess loss.)

#### **Groups positively and negatively impacted:**

- Since limiting itemized deductions would be an effective broadening of the base of taxation, positive impacts would be isolated to beneficiaries of the higher General Fund revenues.
- Negatively impacted entities would include charitable foundations, lower-income filers, taxpayers with retirement income, households that currently itemize deductions, and filers reporting federally taxable military pay. Homebuilders would object due to the loss, or partial loss, of the home mortgage interest provisions.

**Other states:** Illinois – no standard deductions or itemized deductions; Indiana – no standard deduction, itemized deductions include a renters deduction and homeowners residential property tax; Missouri – standard deductions same as federal and itemized deductions same as federal with modifications to taxes paid; Ohio – no standard deduction or itemized deductions; Virginia – standard deduction \$3,000 single or married filing separately and \$6,000 if married, and itemized deductions same as federal with modifications to taxes paid and gifts to charity; and West Virginia – no standard deduction or itemized deductions. Indiana, Missouri, and Ohio have deductions for social security benefits and interest on U. S. obligations.

**Revenue Score:** Various itemized deductions are included in the Tax Expenditure Report. If the Commission elects to further explore the removal of certain itemized deductions, the State Budget Office has some limited data that could be used to estimate the impacts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	N	+

## Proposal # 9: Make taxable income equal to the federal Adjusted Gross Income (AGI) less a significant standard deduction and tax credit for low income households

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** In common parlance, this proposal would be classified as a move to a “flat income tax”. Such a proposal has several potential advantages. A flat tax proposal with fewer exclusions, exemptions, and deductions is consistent with a broad theme of a wider tax base with the potential for a lower rate of taxation. A flat tax also has the potential to simplify the State taxation of income by removing deductions and credits that require additional forms.

However, the proposal would create some inherent downside challenges. Closer conformity the federal adjusted gross income as the Kentucky base of taxation would make Kentucky somewhat more vulnerable to changes to Federal tax law changes. Second, a flat rate of taxation would eliminate the progressivity built into the current rate schedule which allows the rate of taxation to increase as taxable income rises. Third, the implementation of a flat tax would eliminate many deductions, such as itemized deductions and state-specific tax credits. More generally, a flat tax reduces the opportunity to offer tax incentives for engaging in socially desirable behavior, such as home ownership, the accumulation of retirement income and donating to qualified charities – not to mention the changes that would affect the after-tax compensation for persons in military service.

By virtue of taxation based on federal AGI, under this proposal, Kentucky deductions and credits would be eliminated. For example, Kentucky recently passed a 100% exclusion of non-hazardous military pay. This portion of the law would be eliminated under this proposal.

Items that would become taxable by virtue of switching to a flat tax on Federal AGI include the items listed below:

- Post-tax health insurance premiums
- Active Duty Military Pay
- Military Pay for non-active duty personnel
- Tobacco quota buyout income
- Tobacco loss assistance income
- Interest income from U.S. government bonds and securities
- Pension/Retirement income (no longer able to exclude \$41,110)
- Taxable Social Security and Railroad Retirement Board Benefits
- Long-term care insurance premiums
- Income from precinct workers
- Capital gains taken by eminent domain
- Itemized deductions, including but not limited to:
  - Medical expenses, to the extent that the expenses exceed 7.5% of the taxpayer's AGI. The 7.5% floor means that most taxpayers are unable to take advantage of the medical expense deduction.
  - Mortgage interest and points paid
  - Charitable contributions to allowable recipients
  - State and local taxes paid, including:
    - Income taxes (or, alternatively, state and local general sales taxes)
    - Vehicle registration license fee
    - Property taxes (assessed by reference to the value of the property)

**Other states:** States have increasingly looked at reducing itemized deductions as a way to increase tax revenues without changing the tax rates.

**Groups positively and negatively impacted:**

- Depending on the rate chosen for the flat tax, positive impacts would be proportional to income, such that the highest brackets would realize the largest tax reduction vis-à-vis the current method of a slightly progressive rate structure.
- Negatively impacted entities would include charitable foundations, lower-income filers, taxpayers with retirement income, households that currently itemize deductions, and filers reporting federally taxable military pay.

**Revenue Score:** Dependent upon the flat rate selected. Preliminary calculations suggest that a flat rate of about 4.2 percent is roughly revenue neutral to the current baseline forecast of revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	N	+

## Proposal # 10: Tax Retirement income

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** While policies vary widely, all state exclusions of some pension income have one of two purposes:

- Protecting the income of those no longer in the workforce
- Economic development – to attract or retain retirees

This policy would be a dramatic change from the current exemption of \$41,110 per individual. Kentucky currently has an exclusion of all “retirement-plan” income below \$41,110, including income from IRAs, public pensions, private pensions, and various related plans. One proposal under consideration is to do a dollar-for-dollar reduction of the exclusion for all pension income over \$41,110.

For example, if a filer has \$51,110 in retirement income, currently the taxpayer would use the \$41,110 exemption and have \$10,000 in taxable income.

Under the proposed modifications, the amount of the pension exclusion would be equal \$41,110 minus  $(\$51,110 - \$41,110) = \$10,000$ , so the taxable pension income would rise from \$10,000 to \$20,000. At \$82,220 the modified plan would have no retirement income exempt from state taxation.

**Revenue Score for the phase-out above:** +\$145.0 million

If all retirement income were taxed, including social security, the annual gain in revenue would be approximately \$425 million. A more moderate approach, along the lines of some of competitor states that offer exemptions on the order of \$10,000 - \$12,000 would reduce the impact of these changes on all households who receive retirement income, particularly those with the lowest incomes. Scores are being developed for a wide range of retirement options.

**Other states:** Most states that levy a personal income tax allow people who receive retirement income to exclude part of it from their taxable income. Of the 41 states with a broad based income tax, 36 offer exclusions for pension income. Some states limit exclusion of pension income when significant non-pension income is reported.

According to a 2011 report from the National Conference of State Legislatures (NCSL), “States take two broad approaches to excluding retirement income from taxation. Some states provide a specific amount of exclusion according to the type of retirement income...Other states (and some of the same states) provide a retirement income exclusion that taxpayers over a specified age, usually 62 or 65, can apply to non-earned income and in rare instances to some earned income...In addition to those in Colorado and Virginia, exclusions of this sort exist in Arkansas, Delaware, Georgia, Idaho, Iowa, Kentucky, Maine, Maryland, Minnesota, Missouri, Montana, New Jersey, New Mexico, North Carolina, Oklahoma, South Carolina, Utah and West Virginia. The amount of the exclusion varies from \$2,000 in West Virginia to \$41,110 in Kentucky.”

**Groups positively and negatively impacted:** Retirees would be negatively impacted. Generally, retired households have more freedom and resources to locate or relocate in states with favorable weather low taxes. Taxation of retirement income would impede Kentucky’s ability to retain and attract retirees. Retention of retired citizens would be marginally more difficult since retirement income (unlike earned income) can freely migrate to non-taxed jurisdictions. It would also be marginally more difficult to attract newly retired households. In a broader

view, the choice of where to retire is a function of many factors: 1.) ties to family; 2.) ties to local friends and churches; 3.) a favorable tax code, and 4.) the entire tax code beyond the taxation of retirement income. Kentucky has low property tax rates, which would help retired households. Kentucky also has a narrow base of taxation with a relatively modest sales tax rate. Groups positively impacted would be anyone advocating for increased state revenue.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	+

**Additional Considerations:** The 2009 Statistics on Income tax data reports that approximately 486,000 Kentucky returns include retirement income that is taxable at the Federal level. The taxable federal income is approximately \$8.5 billion, and the total taxable federal income (from all Kentucky income taxed at the federal level) is about \$84.1 billion. If the exclusion were lowered to any point between the current amount and \$0 there would be a sizeable increase in tax receipts, but the magnitude would be determined by the distribution of exclusions and marginal tax rates among the taxpayers. Since all distribution income earned prior to 1998 is 100% exempt for state employees, only income earned by retirees since that date is subject to taxation if the amount exceeds \$41,110. Lowering the excludable amount to \$0 for that group would generate approximately \$325 million in income tax receipts, while leaving all contributions prior to 1998 unchanged. This number would grow over time as a larger percentage of retirees earn a significant portion of their pensions after 1998.

Since 2005 up to \$41,110 in total distributions from pension plans, annuity contract, profit-sharing plans, retirement plans or employee savings plans has been excluded from the adjusted gross income calculations of Kentucky taxpayers. Taxpayers receiving those distributions from private accounts have been able to exclude up to \$41,110 of all income distributions. Persons receiving benefits based upon their service as a state employee have been able to exclude up to \$41,110 in distributions from service performed in taxable years beginning after 12/31/1997 and 100% of all distributions received based on contributions made prior to that date. KRS 141.010(10)(i)(2) could be amended to change the maximum excludable amount from \$41,110 down to any amount determined.

Legally, Kentucky can only change the exclusion amount from the \$41, 110 on a prospective basis. However, whatever treatment is given to state pensions must also be extended to federal, pursuant to Davis v. Michigan.

Moreover, we cannot change the provisions of KRS 141.021 and KRS 141.0215 relating to pre 1/1/98 pensions. That is partly based on Davis v. Michigan, and partly based on the inviolable contract language pertaining to state pensions. That's why the 1998 enactment was prospective only, and provided a method for determining pre versus post 1998 accruals.

## Proposal # 11: Remove the spousal division on income and deductions

Amend 103 KAR 17:020 to eliminate the provision that allows a husband and wife to file separately on a combined return.

**Background information:** This individual income tax proposal intends to eliminate the married filing separately on a combined return filing option. Currently, a husband and wife may file a joint return, file separate returns, or file separately on a combined return. Filing separate returns or filing separately on a combined return allows both the husband and wife to receive a standard deduction (\$2,240 in 2011) and the benefit of the tax brackets which are as follows: (i) 2% of income \$0 - \$3,000; (ii) 3% of income \$3,000 - \$4,000; (iii) 4% of income \$4,000 - \$5,000; (iv) 5% of income \$5,000 - \$8,000; (v) 5.8% of income \$8,000 - \$75,000; (vi) 6% of income over \$75,000.

Filing separately on a combined return frequently will result in a smaller tax liability for a husband and wife in comparison to choosing the filing option of married filing jointly.

**Other states:** No other surrounding state allows a husband and wife to file separately on a combined return. Most surrounding states have a standard deduction similar to federal, which provides a larger standard deduction for a husband and wife filing a joint return.

**Groups positively and negatively impacted:** Positively impacted – the General Fund. Negatively impacted – married taxpayers who choose the married filing separately on a combined return filing option. Married taxpayers would oppose the elimination of filing separately on a combined return unless the standard deduction is increased. If the standard deduction is increased for married taxpayers filing a joint return, this proposal would be better received.

**Revenue Score:** An increase to the General Fund will result. In 2011, 457,000 married taxpayers filed separately on a combined return which allowed both the husband and wife the benefit of the lower income tax brackets which saved them approximately \$184 on each return or \$84,088,000 for all tax returns. To insure the large increase in revenues projected, the law needs to be amended to provide that a husband and wife filing separate returns would each receive one-half of each income bracket.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	N

## CORPORATE TAXES

### Proposal # 12: Add back management fees in calculation of the corporate income tax base

*Note:* This is a proposal from both the Consultants to the Commission and the Department of Revenue.

**Background information:** This proposal would prevent abuse of management fees that reduce Kentucky income taxes. A frequent aggressive tax planning device under the corporation income tax law is the use of intercompany transactions related to intangible assets, which greatly reduces income that would otherwise be taxable. One strategy used is to inflate inter-company intangible expenses or management fees paid to an affiliate that is domiciled in a state that does not tax income. In other words, a Kentucky taxpayer claims the inter-company expense as a deduction on their Kentucky return. In turn, the affiliate that receives the payment is not taxed on that income in their state of domicile. By applying the requirements that already exist for intangible interest expenses and intangible expenses to management fees, this would strengthen management fees add-back language.

**Other states:** Illinois, Ohio, Tennessee and West Virginia require unitary combined reporting, which eliminates the deduction of management fees by including both the recipient and payer of the management fees in the combined return. Indiana provides that management fees create nexus for the recipient. Virginia disallows management fees unless the taxpayer can substantiate that the management fees are necessary and reasonable.

**Groups positively and negatively impacted:** Positively impacted - Corporations currently paying Kentucky income tax on management fees would benefit from a level playing field. Negatively impacted - Large multi-state, vertically integrated corporations that utilize inflated management fee deductions to reduce their Kentucky corporation income tax liability.

**Revenue Score:** Up to \$13 million increase to the General Fund per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	N

### **Proposal # 13: Allow companies that are approved for state corporate tax credits under the state's incentive programs to sell those credits on the market to other companies that can utilize them to offset their state corporate tax liability**

**Background information:** Economic incentives have been enacted over time with various purposes as the end objective. Many of these credits are profiled in the Tax Expenditure Report. However, the impacts listed in that report are primarily a scorecard of tax incentives that will be utilized in a given year. The amount of credits used as a percentage of the credits awarded is very small. Many of the credits can be carried forward to be used in future tax periods, but the ultimate use depends on a future tax liability sufficient to use the entire credit.

The proposal to sell, or transfer, credits to another Kentucky taxpayer would certainly increase the percentage credits used. It would be atypical for a business to purchase tax credits if the business did not have a corporation income or LLET tax obligations expected in the future.

Economic development credits are based on a theoretical notion of “performance-based”. State boards and agencies that approve credits want to see successful usage of their programs. The safeguard to the state is that a net impact should accrue to Kentucky if the level of commerce specified at the time of final approval is met or exceeded. If a business does not produce the level of activity that corresponds to the levels projected, the usage of incentives as tax credits would drop. The whole concept of performance-based incentives is undermined when businesses can sell their credits to other companies.

**Other states:** Several states allow the transfer and sale of certain tax incentive programs that can be claimed against corporate taxes. Some examples are:

- California, Illinois, & Massachusetts motion picture incentives may be sold and used against corporation income tax.
- Louisiana allows the sale of angel investor credits and the historic rehabilitation credits and these credits can be used against corporation income tax.
- The New Mexico Rural Jobs Tax credit may be sold and used against corporation income tax.
- Missouri allows the sale of tax credits under several programs, including enhanced enterprise zone tax credits. These credits can be used against corporation income tax.

**Groups positively and negatively impacted:** Three different sectors will reap the highest benefits. First, the firm selling or transferring tax credits will benefit, since the credits have limited usefulness when profits are not present to create a tax liability. Second, the brokers who work between the buyers and sellers of credits will have a large, newly-created marketplace. Third, the firms buying the credits will likely buy them below face value, thereby eliminating a tax obligation for less than par value.

**Revenue Score:** Given the large balances of unused credits, an unrestricted marketplace of credit vouchers could conceivably wipe out a large percentage of the corporate income and limited liability entity taxes. To keep the fiscal impacts under \$100 million annually, an annual cap of total credits to be transferred must be considered.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	-

## Proposal # 14: Create an R&D Tax Credit

**Background information:** Kentucky already has a research and development tax credit. The credit may be applied against corporation income tax, individual income tax and the limited liability entity tax. The credit is five percent of the qualified costs of “construction of research facilities.” "Construction of research facilities" means constructing, remodeling, and equipping facilities in this state or expanding existing facilities in this state for **qualified research** and includes only tangible, depreciable property, and does not include any amounts paid or incurred for replacement property. The current law relies on the federal definition of “**qualified research**”. Unused credit may be carried forward for 10 years.

**Other states:** 38 states have a research and development tax credit.

**Groups positively and negatively impacted:** Since a credit already exists, the impact on various groups is unknown unless the proposer intends for a different credit to be enacted.

**Revenue Score:** Unknown. There is no cap on the current credit.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	N	-	-

## Proposal # 15: Create a tax credit for businesses that support private and public schools

**Background information:** This proposal refers to an income tax credit based on contributions to scholarship organizations that support private and public schools. Both House Bill 66 and House Bill 98 of the 2012 Regular Session proposed an income tax credit for contributions made to eligible scholarship organizations, but neither passed.

“Tuition tax credits are a growing school choice option some states are exploring,” according to the National Conference of State Legislatures. As of May 2011, tuition tax credit programs exist in nine states. These programs, also known as scholarship tax credit programs, allow individuals and corporations to allocate a portion of their owed state taxes to private nonprofit school tuition organizations that issue scholarships to K-12 students. The scholarship allows a student to choose among a list of private schools, and sometimes public schools outside of the district, approved by the student tuition organization... Supporters of tuition tax credits say they save the state money because annual tuition at a private school is typically less than the per-pupil cost at public schools.”

However, according to a recent article in Education Week, detractors “describe them as vouchers in disguise, and say that estimates of cost savings are speculative and likely exaggerated. Critics also say some states’ programs lack transparency, and include loopholes that can allow families and private schools to game the system, at a cost to taxpayers.”

**Other states:** None of the surrounding states award tax credits to businesses that support private or public schools. Indiana and Missouri award tax credits to businesses that contribute to a college or university scholarship fund.

**Groups positively and negatively impacted:** Public schools, and other programs funded by the General Fund.

**Revenue Score:** The proposed income tax credit would decrease General Fund receipts, however no data exists to estimate how many contributions may be made.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	-

## Proposal # 16: Eliminate capital gains tax for any early stage company that is headquartered in Kentucky

**Background information:** Currently, capital gains from the sale or exchange of qualified early stage companies headquartered in Kentucky are taxed by Kentucky. Capital gains are included in Kentucky taxable income and taxed as ordinary income subject to the statutory rates provided for individual income tax and corporation income tax. Kentucky does not have a special tax rate for capital gains.

Further research needs to be conducted to ensure the legality of offering tax incentives to reduce capital gains taxation on the basis of physical location of the company or assets being sold.

**Other states:** None of the surrounding states have a tax provision that excludes from taxable income capital gains on the sale or exchange of qualified early stage companies headquartered in their state.

**Groups positively and negatively impacted:** Positively impacted - the exclusion of such capital gains from Kentucky income tax should increase the number of early stage companies to headquarter in Kentucky which would increase economic activity in Kentucky. Negatively impacted - General Fund revenues may initially decrease by the amount of the tax on the exclusion of such capital gains, but the amount would not be material.

**Revenue Score:** The exclusion of such capital gains from Kentucky tax should increase the number of early stage companies to headquarter in Kentucky which would increase economic activity in Kentucky; consequently, the benefit should exceed the cost over time.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	-

## Proposal # 17: Implement single factor apportionment

*Note:* This is a proposal from the Consultants to the Commission.

**Background Information:** Apportionment is the method of determining the portion of corporate income or pass-through entity distributive share income taxable in a state in which the corporation or pass-through entity is doing business. In Kentucky, a 3-factor formula of sales, property and payroll is used to apportion a multi-state corporation's or pass-through entity's income to Kentucky to compute income tax. The sales factor is double-weighted. A change to a single factor apportionment based on sales only has been utilized by other states to assist economic development. If such a change was adopted in Kentucky, the apportionment formula would become Kentucky sales divided by total sales. Single-factor apportionment has been suggested as an additional tool for industrial recruitment.

The change to single factor apportionment is primarily done to preserve or add jobs. Some corporations will pay more and some will pay less in Kentucky if single factor apportionment is adopted. Some states limit the single factor based on sales to manufacturers. Other states allow the single factor based on sales as an election.

In the formative years of apportioning income, all states placed essentially equal weight on the three factors. Further, states have traditionally situated sales of goods to where the market is located (on a destination basis). As a result, there has been a strong tendency to increase the weight on sales in the formula, which moves the tax towards a sales tax at a rate that depends on the profitability of the corporation. Kentucky double weights sales (puts 50 percent weight on the sales factor) in the formula. At least 14 states now use single factor apportionment based on sales and another four or more states have greater weight than Kentucky, but do not have single factor apportionment. Movement to single factor sales weighting of the corporate income tax has been justified as a way to reduce taxation of production because the tax becomes linked to the amount of sales in a state and not the amount of employment, investment or production. Changes in the apportionment formula weightings have no implications for a firm that produces and sells its entire product in Kentucky since apportionment only applies to multi-state businesses.

The effects of increasing the weight on sales and decreasing them on employment and production in a state depend on the net of several factors. Greater emphasis on the sales factor raises the tax on purchases by in-state buyers (some of whom are businesses producing in the state) which presumably discourages buying (or at least raises the costs for corporations to sell) in the state by both businesses and consumers. On the other hand, lower weights on property and payroll reduce the costs of hiring workers and using physical capital in the state. The net effect is an empirical question. Research generally finds that state economies are stimulated by greater emphasis on the sales factor (moving towards a destination tax), but the effects on individual states depend on specific characteristics of the region where the state is located.

Assuming no change in purchasing patterns, increasing the weight on the sales factor means more tax revenues will be remitted by firms that produce relatively less in a state than they sell and the reverse for firms that produce more than they sell. The effect on aggregate revenue depends on the net effect of the two groups of firms plus any influence on firm and consumer behavior as the tax structure is altered. The overall research has somewhat mixed results with some suggesting more revenues and some less revenues.

**Groups positively and negatively impacted:** Big companies with a significant physical presence in Kentucky that include lots of payroll and property will see a significant tax savings. This includes large manufacturers and others that have a lot of plant, equipment and employees located here that also have a small % of their U. S. sales in Kentucky. A corporation that is headquartered here would benefit from a single sales factor. Companies with little physical presence and significant sales in Kentucky will pay more income tax under this proposal. In

2009, Kentucky Department of Revenue research revealed that there will be some corporate taxpayers with a presence in the state that will see an increase in their corporate tax.

**Other States:** Approximately 18 states have changed from the standard 3-factor formula to a single-factor formula based on sales.

<b>State</b>	<b>Apportionment Method</b>
Ohio	3 factor/triple weighted sales
Indiana	Single-sales factor phased in by 2011
Illinois	Single-sales factor
Missouri	3-factor w/single-sales factor election
Tennessee	3-factor/double weighted sales factor
Virginia	3-factor/double weighted sales factor w/single-sales factor phased-in for manufacturers by 2014.
West Virginia	3-factor/double weighted sales factor

**Revenue Score:** \$65 million loss to the General Fund per fiscal year.

<b>SCORE ON TAX REFORM PRINCIPLES</b>				
<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
-	+	-	-	+

## Proposal # 18: Lower the \$3.0 million LLET threshold to \$1.0 million and phase out the effects through \$2.0 million

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "Kentucky made a number of changes in its corporate tax structure in 2005 and 2006. Like most states, Kentucky did not revise its tax statutes when it legislated the LLC, in 1994, as a possible organizational structure and later imposed the corporate income tax on LLCs. Kentucky also enacted a minimum tax as a percent of gross receipts as part of the corporate income tax structure. Subsequently, the limited liability entity tax (LLET), which is levied on all firms with limited liability including C-corporations, was enacted and LLCs were exempted from the corporate income tax.

The LLET imposes the minimum of 0.75 percent on profits or .095 percent of gross receipts. Companies paying the corporate income tax are permitted a non-refundable credit against the LLET for corporate income taxes that are paid. The LLET limits the extent of tax planning for Corporations and imposes a small tax on LLCs.

Kentucky could move back to a single tax by building the minimum gross receipts tax into the corporate income tax structure and imposing the corporate income tax on LLCs. This improves the tax structure since LLCs and LLPs are often used inside of corporate umbrellas for tax planning purposes. The LLET collects some tax from LLCs and unprofitable corporations, but still gives companies an incentive to tax plan using LLCs inside the corporate structure.

A much more restricted alternative is to lower the threshold that determines the minimum amount paid under the LLET to \$1.0 million (or less) and phase out the benefits of the exemption until \$2.0 million in revenues. The revenue threshold in the LLET is relatively large. Currently, a minimum \$175 tax is levied on limited liability entities with \$3.0 million or less in revenues and the benefits are phased out through revenues of \$6.0 million.

A decision on the appropriate threshold should be made after considering effects on administration and compliance, revenues, and economic efficiency. Taxing all transactions in a similar fashion lessens distortions in business practices and consumer purchases and imposing special rules such as thresholds is likely to create unintended consequences.

The \$3.0 million threshold places a kink in the tax system where essentially no compliance is necessary below the legislated amount and full compliance is necessary above the amount. Behavioral changes can be expected when certain taxpayers are omitted from the tax and the potential for distortions rises with the size of the threshold. For example, companies could seek to avoid the tax by splitting into multiple businesses, each operating just below the threshold. Vendors in certain industries, and particularly ones characterized by low productivity, will be most likely to operate below the threshold. LLET revenues are surely reduced significantly by the threshold. A larger threshold reduces the number of firms required to comply with the LLET, which essentially eliminates compliance costs for the firms and reduces the number of taxpayers that Kentucky must control.

It is important to remember that the administrative costs for firms below the threshold are not eliminated since Kentucky still must do some audit of whether firms meet the minimum threshold for compliance and the possibility exists that firms will intermittently comply as they exceed the threshold some years and not others. The \$3.0 million threshold means that 82 of percent limited liability entities pay the minimum \$175 tax. Certainly, some of the reason is that the kink in taxes at \$3.0 million provides firms with an incentive to stay

small or to divide into small firms. Some examples exist from practice around the world. Ohio established a \$1.0 million threshold for the CAT and a strong case can be made that this is too high. No country in the European Union allows a threshold above approximately \$140,000.

**Other states:** Few states have adopted LLET taxes, but the ones that do have a gross receipts threshold for small business that is much lower than Kentucky.

**Groups positively and negatively impacted:** Positively impacted – advocates for increased state revenue. Negatively impacted – business entities that previously qualified for the \$175 minimum.

**Revenue Score:** +\$14.2 million (based on lower the \$3.0 million LLET threshold to \$1.0 million and phase out the effects through \$2.0 million).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	N

## Proposal # 19: Allow angel investors to qualify for tax credits under the Kentucky Investment Fund Act

**Background information:** KRS 154.20-250 to 154.20-284 is known as the Kentucky Investment Fund Act. KRS 154.20-258 allows an investor a nonrefundable credit equal to 40 percent of the investor's proportional ownership share of all qualified investments made by the investment fund. Eligible investment funds are approved by the Kentucky Economic Development Finance Authority. The nonrefundable credit may be applied against individual income tax, corporation income tax or limited liability entity tax.

Current law provides that the total amount of tax credits available to any single investment fund shall not exceed, in aggregate, \$8 million for all investors and all taxable years. The total tax credits available for all investors in all investment funds shall not exceed \$40 million.

**Other states:** Illinois has an angel investor tax credit. Indiana, Missouri, Ohio, Tennessee, Virginia and West Virginia do not have an angel investor tax credit.

**Groups positively and negatively impacted:** Positively impacted - angel investors investing in qualified activities provided by the Kentucky Investment Fund Act. Negatively impacted – no one, unless the \$8 million or \$40 million limitations are changed.

**Revenue Score:** Unknown impact on the General Fund. New angel investors may stimulate economic development in Kentucky, which could generate additional tax revenue. Only \$6.5 million of the total \$40 million tax credits authorized by the Kentucky Investment Fund Act have been awarded since its inception on July 15, 1998; therefore, angel investors could be included under this act without increasing the cap.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	N

## Proposal # 20: Replace the Corporate Income Tax and LLET with a Gross Receipts tax or with some other sources of revenue

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “Michigan, Ohio, Oklahoma, and Texas, recently imposed differing versions of a gross receipts tax (GRT) on all businesses, including corporations and unincorporated businesses. A number of other states, including Washington and Delaware, have imposed such taxes for many years. Kentucky could impose a similar tax, and already does to some extent with the gross receipts alternative base under the LLET. The GRT would differ from a sales tax in that no exemptions would be allowed but also in that the rate would be very low (Ohio’s rate is 0.26 percent). Implications of the GRT for Kentucky’s economic activity can be limited by imposing the tax only on transactions that have their destination rather than their origin in Kentucky. Thus, no tax would be imposed on sales by Kentucky firms to businesses and residents outside the state. Tax would be imposed on all sales to buyers in the Commonwealth, whether the purchaser is a consumer, business or government. Additional cost would be imposed on firms operating in Kentucky if they buy inputs (on which the tax would also be levied). The component imposed on inputs would be implicit in the costs of operation in Kentucky whether the firm sells to Kentucky or out-of-state buyers.

A GRT can expand the set of business taxpayers by including unincorporated businesses and firms protected from corporate income taxes by the PL 86-272 constraint. PL 86-272 is a limitation on income based taxes, so it may not apply to a gross receipts tax, depending on how the courts ultimately rule on this issue. GRTs are also a means to expand the taxation of the service economy relative to the goods economy since service firms are less likely to be incorporated (which means they are not paying the corporate income tax) and their sales are less likely to be taxable through the sales tax. Further GRTs are a means to limit tax planning, since managing the corporate profits that are reported for tax purposes is a common form of planning and it is more difficult to tax plan around gross receipts taxes.

Economists generally object to gross receipts taxes because the extent to which the tax is built into prices (i.e., the tax cascades) depends on the number of steps that items pass through in the production process. Cascading distorts relative prices compared with a uniform tax on all consumption and should cause consumers to buy relatively less goods and services where the greatest cascading occurs.

A related problem is that firms may choose to vertically integrate to avoid the tax, which reduces efficiency if firms are only integrating to avoid the tax. A low tax rate should lessen the concerns about vertical integration and distortion of behavior. A State of Washington study measured the degree of cascading from a GRT (defined as the effective tax rate on an industry divided by the actual tax rate) for a range of different industries. On average the effective rate was 2.5 times the stated tax rate, but the degree of cascading varied from 6.7 times for industries such as food manufacturing and petroleum refining to 1.4 times for data processing.

Individual businesses may object to a GRT either because they do not understand it or because their tax liability rises. Assuming revenue neutral imposition of the tax, unincorporated, unprofitable, and service firms will generally see a tax increase and incorporated, profitable, and heavier industries will see a decrease. Firms with very low markups (such as grocery stores) will be particularly likely to object because they will view the tax liability as large relative to their gross margin.

A GRT would entail lower administration and compliance costs than the existing taxes, since firms would only need to calculate sales in Kentucky and would not need to calculate profits. For corporations, the tax base can be thought of as the numerator for the sales factor in the corporate income tax formula, which is simpler to

calculate. The Ohio tax return is essentially a postcard because it only requires gross receipts, an exclusion, and calculation of tax liability. On the other hand, movement to a new tax structure entails a series of transition concerns. Issues will need to be decided such as, how are accrued credits to be treated, will firms be able to carry losses developed prior to the tax forward, how will previously promised tax incentives be handled and so forth.

Calculating the revenue neutral GRT rate is complicated because it requires estimating the total number and value of transactions in the Kentucky economy and making assumptions about the extent to which deductions or exemptions would be allowed. Ohio adopted a very broad based tax with very few exemptions; though the Ohio statute allows a \$1 million exclusion from the base (a \$150 minimum tax is imposed). The Ohio experience provides a pattern for estimating the lowest possible rate that could be imposed in Kentucky (since the base is so broad). The Ohio Department of Taxation reports that total gross receipts reported on tax returns were \$665.2 billion in 2008 and taxable gross receipts after the exclusion were \$579.5 billion, which is 1.23 times the size of Ohio Gross Domestic Product. Then assuming that taxable gross receipts in Kentucky would be also be approximately 1.25 times its GDP of 164 billion, to raise the loss revenue from the Corporate Income Tax and LLET of \$675 million, the tax rate would need to be .33%.

Alternatively, another option would be to entirely eliminate the corporate income and LLET taxes and replace with other sources of revenue, presumably taxes on consumption rather than business. State corporate income taxes are justified on several grounds but none of them appear to hold up well to scrutiny. Corporate income taxes are generally intended to raise revenue, but the question remains why this tax is the best option for generating revenues. Two explanations are often given for choosing the corporate income tax relative to alternative revenue sources, such as personal income, sales or property taxes: to tax retained earnings or as a payment for the benefits from public services. Several other arguments for corporate taxation are also mentioned occasionally, including because businesses are an easier point than individuals for collection of taxes and as a means of diversifying government tax instruments. The latter two probably are not good justification in Kentucky.

Corporate income taxes could be imposed to ensure taxation of retained earnings. In the absence of a tax on retained earnings, individuals have the incentive to house their assets and incomes in a corporate structure to avoid the individual income tax. The argument surely has some merit at the national level, but existence of the federal corporate income tax may be sufficient to limit the use of the corporate form to avoid the individual tax and should preclude the need for state corporate taxes for this purpose (particularly if Kentucky requires taxpayers to file in Kentucky in the same way as nationally). Further, a corporate income tax on retained earnings should be paid where the owners of capital (the shareholders) reside, but the corporate income tax is apportioned to the state where firms' physical assets or the market for their product is located. Thus, the corporate income tax accrues to the wrong state, and likely at the incorrect rate, to attain this objective.

The corporate income tax may be intended as a charge for the benefits that firms receive from public services. The public sector provides corporations with limited liability, which could be justification for a tax only on firms granted limited liability but this certainly argues for a tax on all firms with limited liability and not just C-corporations. Business taxes, such as the corporate income tax, have also been justified as a means of charging for the broader public service benefits available to businesses, such as access to the legal system and a trained labor force. A tax levied only on corporations is too narrow to serve as a charge for general public service benefits, because all firms, whether corporations or pass-through entities and whether profitable or not, benefit from public services. Thus, a benefits tax justification argues for a broad tax on business. But, businesses pay the range of other taxes, such as the sales, property, and unemployment insurance taxes, and pay approximately 40 percent of all taxes (see Ernst & Young, 2012). It seems unlikely that the public service benefits accruing to corporations are sufficient to justify an additional tax on corporations based on the benefits they receive.

The CIT and LLET generate very little revenue in Kentucky and much of the tax is likely to be reflected in lower wages for Kentucky workers or higher product prices for Kentucky buyers. The Commonwealth could choose to tax people directly by replacing the corporate and LLET tax revenue with a broader sales tax base or by raising the personal income tax rate. Effectively, the argument is that it is more efficient to impose taxes directly on people than to impose taxes on corporations with the expectation that the tax will be passed forward to people in higher product prices or lower wages. The state's economy will be strengthened by not using business as an intermediary to tax people. Further, Kentucky would receive the public relations benefit of saying that the state imposes no tax on corporations. As described above, the academic literature indicates that lower rates offer some economic benefits by attracting business activity, and a 0 rate would offer the greatest advantage.

**Groups negatively and positively impacted:** Positively impacted – business entities with large physical presence in Kentucky but with low gross receipts situated in Kentucky. Negatively impacted – companies including high-volume retailers or unprofitable business entities.

**Other states:** Ohio is the only surrounding state that has a gross receipts tax, which is the Commercial Activity Tax (CAT). The CAT is \$150 for gross receipts of \$150,000 to \$1 million with gross receipts over \$1 million at \$150 plus \$0.26%. Illinois, Indiana, Missouri, Virginia, and West Virginia all have an income tax.

**Revenue Score:** Revenue neutral depending on GRT tax rate.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	N	-	+

## Proposal # 21: Require combined reporting for corporations

**Background information:** Combined reporting is a corporation income tax reporting requirement that many states have adopted attempting to address reductions to the tax base from the elimination of income via inflated expenses attributable to inter-company transactions. A combined return is sometimes referred to as a “unitary” return. The group of affiliated corporations included in a combined return must demonstrate a unity of ownership, operations and management. Not all members of a large corporate structure are necessarily included in the same combined return.

Kentucky’s current corporation income tax laws require a separate company return or a nexus consolidated return from corporations that are doing business in Kentucky. A separate company return is one filed for a single corporation. A nexus consolidated group return is a return filed by an affiliated group of corporations that are connected by 80% or more ownership. A nexus consolidated group can have the same members as a combined group. Frequently, however, some of the members of a combined group are not able to be included in a nexus consolidated group return.

All of the corporation income tax return filing methods are complex. Combined reporting requires a greater level of sophistication from both a taxpayer and a Revenue perspective, as it is more difficult to administer than other income tax return filing methods. Combined reporting also is viewed as a disincentive for locating in a state from an economic development perspective. A combined report can result in a higher taxable net income computation for a company headquartered in a combined reporting state than would be its taxable net income amount under other filing options.

**Other states:** 21 states with a corporation income tax have a mandatory combined reporting requirement.

**Groups positively and negatively impacted:** A mandatory combined reporting requirement will create winners and losers. Positively impacted – those affiliated groups that would pay less under combined reporting. Negatively impacted – those affiliated groups that would pay more under combined reporting.

**Revenue Score:** Unknown fiscal impact which must be scored based on switching from the current filing requirements to a combined reporting requirement.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	N	N	-

## Proposal # 22: Review tax incentives or loopholes for the coal industry

**Background information:** Coal companies can deduct transportation expense from the amount of severance tax owed, and there is also a thin seam credit allowed under the coal severance tax. Other tax credits are available in the income tax laws but they do not affect severance tax receipts. The income tax credits are the coal incentive tax credit and clean coal tax credit.

**Other states:** Other coal producing states have incentives related to the coal industry. Montana has a corporation income tax incentive for exploration activity costs for each distinct mining operation for mineral or coal deposits in Montana. West Virginia has a Business Franchise Tax and Severance Tax credit for the purpose of building or constructing a new or expanded coal loading facility or for taxpayers that revitalize an existing coal loading facility.

**Groups positively and negatively impacted:** Positively impacted - existing incentives benefit the coal industry. Negatively impacted – unknown.

### Revenue Score:

In FY 2012, the deduction for transportation on severed coal was \$22,807,589.

In FY 2012, the deduction for transportation on processed coal was \$1,700,182.

In FY 2012, the thin seam severance credit was \$3,068,657.

For 2010 income tax returns, \$2.1 million in coal-related credits were claimed.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	N	N	N

## Proposal # 23: Use destination sourcing for services

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** Sourcing of service revenues relates to determining the numerator of the sales factor portion of the corporation income tax apportionment factor. The three factor apportionment formula is based on sales, property and payroll. The apportionment factor computation is required for corporations taxable in this state and taxable in another state. Current law requires service revenue to be sourced based on cost of performance.

Under the current cost of performance rule, a sale is assigned to Kentucky if the majority of the service's cost is performed in Kentucky. Under a market sourcing approach, only services with a Kentucky end destination will be assigned to the numerator of the Kentucky sales factor as a Kentucky sale. Switching to market-based sourcing could result in more litigation than currently occurs under cost of performance.

The limited liability entity tax also is impacted by this issue as multi-state service corporations determine their limited liability entity tax base by using the numerator of the Kentucky sales factor from the corporation income tax apportionment factor computation.

**Other states:** Illinois and Ohio have adopted market-based sourcing. Indiana, Missouri, Tennessee, Virginia and West Virginia source service revenue based on cost of performance.

**Groups positively and negatively impacted:** Positively impacted - service businesses whose operations are primarily in Kentucky. Negatively impacted - service businesses whose operations are located primarily outside of Kentucky and provide services to Kentucky customers.

**Revenue Score:** The fiscal impact is unknown, but winners and losers would be created if this proposal becomes law.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	N	Unknown	+

## Proposal # 24: Fully decouple from the deduction for U.S. production activities (QPAI)

**Background information:** This proposal intends on eliminating the deduction that applies to both corporations and individuals. Previously, section 114 of the Internal Revenue Code excluded “extraterritorial income” which constituted “qualifying foreign trade income” under former section 941 from income. This encouraged U.S. businesses to export. However, that section was ultimately held to be a prohibited export subsidy by the World Trade Organization, and repealed. To offset the loss of this benefit, Congress enacted Section 199 regarding qualified production activities income (QPAI). QPAI is defined as the portion of taxpayer income which is equal to the excess of the taxpayer’s domestic production gross receipts over the sum of the cost of goods that are allocable to such receipts and other expenses, losses or deductions which are properly allocable to such receipts. The effect of this law is to encourage domestic production. Manufacturers who qualify can deduct nine percent of their QPAI on their federal return.

Several states allow this deduction at the state level. Kentucky adopted the deduction for U.S. production activities for tax periods beginning on or after January 1, 2005. It largely follows the federal deduction with the computation rate capped at six percent.

**Other states:** At least 19 states do not allow this deduction. Approximately 20 states allow the deduction in the same amount as the federal deduction.

**Groups positively and negatively impacted:** Those currently receiving the deduction would be negatively impacted. If the deduction is eliminated, there would be an increase to the General Fund.

**Revenue Score:** A General Fund increase of approximately \$10 million per year will occur based on the deduction amount claimed on 2010 returns.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	+

## Proposal # 25: Adopt a throwback rule to tax nowhere income

**Background information:** History from Kentucky’s corporate tax statutes related to the throwback rule: The 1962 Kentucky General Assembly enacted the following language related to the apportionment of sales. Prior to this time, Kentucky statutes were largely based on separate accounting and apportionment provisions for multistate business were relatively new. There is at least a perception of double taxation in the following language:

“Receipts from sales and other sources shall be assigned to this Commonwealth if the transaction giving rise to the receipts are chiefly negotiated at an office, agency or place of business of the corporation located in this state, or if the receipts are derived from the sale of property delivered into this state, the place of negotiation of the sale notwithstanding. In no case, however, shall the receipts from a sale be allocated to this state more than once.”

Because of the issues related to the 1962 language, the 1966 Kentucky General Assembly enacted the Uniform Division of Income for Tax Purposes Act (UDITPA) almost verbatim and included the following provision (emphasis added):

*Sales of tangible personal property are in this state if:*

- 1. The property is delivered or shipped to a purchaser, other than the United States government, or to the designee of the purchaser within this state regardless of the f.o.b. point or other conditions of the sale; or*
- 2. The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and the purchaser is the United States government or the taxpayer is not taxable in the state to which the property is delivered or shipped.*

The 1974 Kentucky General Assembly enacted a change to the statute by deleting the bolded language above, thereby eliminating the throwback rule for Kentucky.

In 1974 Kentucky businesses immediately tried to remove this portion of the statute. Today, they continue to oppose the inclusion of the throwback rule in Kentucky’s apportionment language. The economic conditions in a particular state are considered enhanced if there is no throwback rule. In Kentucky, the perceived lack of a throwback rule creates a great business atmosphere and has routinely used that as an example of why businesses should locate here.

Theoretically, the throwback rule was included in the UDITPA language to ensure that multistate income was fully apportioned and to prevent nowhere income. However, since Kentucky and a few other states have not adopted the throwback rule, nowhere income exists today.

This topic of throwback rules relates very closely to closing the loophole on management fees. One way to codify the taxation of management fees is to only recognize these transactions as legitimate if the state of domicile for the performance of management activity taxes the income. If not, then the kick-off of management fees is presumed fraudulent and the fees get “thrown back” to the state of origin.

**Other states:** Approximately 28 states have a throwback rule that involves property shipped from the state to a purchaser in another state and the taxpayer is not taxable in the destination state.

**Groups positively and negatively impacted:** Small business and Kentucky-only businesses would be positively affected by a more level playing field on taxation; multi-state competitors would no longer be able to reduce tax obligations through the process of diverting income away to jurisdictions that do not impose a tax on these fees.

**Revenue Score:** If the throwback rule is adopted, the expected annual yield is approximately \$25million per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	-

## **Proposal # 26: Change the definition of taxable business income to mean “all income which is apportionable under the Constitution of the United States”**

**Background information:** Business income is the amount of a corporation’s income that is apportioned to Kentucky for purposes of computing the corporation income tax. “Business income” is defined under Kentucky law to be: “income arising from transactions and activity in the regular course of a trade or business of the corporation and includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitutes integral parts of the corporation's regular trade or business operations.” This proposal suggests that the current definition of business income needs to change. However, Kentucky Administrative Regulation 103 KAR 16:060 states in part: “The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income that has no rational relationship with the taxing state.”

**Other states:** We found no state that does not contemplate the United States Constitution in their administration of the corporation income tax. The computation of business income is an issue of frequent protest. Sometimes there are disagreements between taxpayers and the Commonwealth as to whether or not a particular item of income is business income subject to tax.

**Groups positively and negatively impacted:** Unknown because, the Constitution is already contemplated in a current Administrative Regulation.

**Revenue Score:** No score applies because the Constitution is already part of the Department of Revenue’s administration of the business income computation.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	N	N	N

## Proposal # 27: Repeal the LLET on businesses experiencing a net loss

**Background:** The definition of Kentucky gross receipts for the recently-enacted limited liability entity tax hinges upon the long-standing apportionment provisions of the corporate income tax. The definition actually states that the amount is equal to the computation of the numerator of the sales factor under the corporation income tax apportionment provisions.

Kentucky's LLET was enacted with the forethought that many taxpayers would not have positive profits that would create an income tax liability. In fact, payment of the LLET creates a dollar-for-dollar credit against the income tax (KRS 141.040 or KRS 141.020). With the low rates of taxation in the LLET, and the generous small business exemptions, 82% of all LLET filers pay the absolute minimum tax of \$175.

Why would a tax be imposed on a business entity that does not earn positive profits? Professor William Oakland, who is credited with the benefit theory of taxation, offers one possible rationale. The consumption and provision of governmental services does not accrue merely to those who pay taxes. Rather, many public goods are provided to society for the benefit of society as a whole. A small contribution via the LLET, then, could be viewed as an illustration that businesses utilize public services regardless of profitability.

**Other states:** Very few states have enacted broadly based taxes on gross receipts. Of those states, no state exempts businesses from the GRT when they are not profitable.

**Groups positively and negatively impacted:** If this proposal were to pass, business with losses would benefit by virtue of not accruing a LLET liability. If the proposal fails to be enacted, the status quo would persist.

**Revenue Score:** A precise score would depend upon the provisions that require all taxpayers to remit the \$175 minimum even if they fail to exceed the small business threshold. This would mitigate the negative fiscal impact somewhat. However, a good percentage of the LLET is paid by loss companies. Profitable companies would get a dollar-for-dollar credit of LLET taxes paid in the form of an income tax credit.

Score on tax reform principles				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	N

## Proposal # 28: Exempt business-to-business transactions, including the purchases of business inputs used for the manufacture of goods

**Background information:** This proposal is profiled under the assumption that the exemption will apply to the limited liability entity tax. Currently, business-to-business transactions are gross receipts subject to the limited liability entity tax.

The present limited liability entity tax gross receipts amount is the same amount of gross receipts that are included in the numerator of the corporation income tax apportionment factor. If this proposal is enacted, there will be a separate computation of gross receipts for each tax.

**Other states:** Most surrounding states have similar laws which subject business-to-business transactions to gross receipts taxes unless specifically excluded by statute. Business-to-business transactions are not excluded from the Ohio commercial activity tax unless a taxpayer elects to file a consolidated return, then taxable gross receipts between members of the group are not subject to the commercial activity tax.

**Groups positively and negatively impacted:** Positively impacted – taxpayers of the limited liability entity tax who presently are required to include gross receipts from business-to-business transactions in the computation of the tax base, e.g. manufacturers. Negatively impacted – the General Fund.

**Revenue Score:** General Fund revenues would decrease by the amount of the limited liability entity tax collected on business-to-business transactions.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	-

## SALES AND EXCISE TAXES

### Proposal # 29: Apply transient room taxes to entire hotel accommodation price

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Changes in the accommodation business environment via online sites makes clarification a must in regards to receipts subject to local and state transient room tax. This clarification will include all amounts paid for staying in a Kentucky hotel or similar accommodation. Currently, any amounts charged or retained by online travel companies for their services are not included in the tax base for the state and local transient room taxes. This legislation would plug the gap in local and state room taxes created by the hotel intermediary companies, or HICs (Expedia, Orbitz, Travelocity, Priceline, etc.), that receive receipts from their transactions with hotel and accommodations providers. The general consumer reserving hotel rooms through an HIC is paying one price for the hotel room. This total should be subject to said taxes.

**Other states:** New York, Alabama, Pennsylvania, North Carolina, Missouri, Florida and the District of Columbia, among others, have seen litigation in this area with mixed results. Ohio had attempted to impose its current Transient Occupancy Tax but the U.S. District Court found the online travel companies not liable. The Multistate Tax Commission is working on a model statute to address this issue.

**Groups positively and negatively impacted:** Positively impacted - Those that will benefit from increased transient room tax receipts such as local tourism development districts and municipalities. Negatively impacted - Hotel intermediary companies, also known as online booking agents.

**Revenue Score:** An increase of \$4-5 million per year in transient room tax receipts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## Proposal # 30: Apply sales tax to pre-written computer software

*Note:* This is a proposal from the Department of Revenue.

**Background information:** DOR is seeking to apply sales tax to a newly developing platform that grants use of prewritten computer software without an actual transfer of that product in tangible form or by electronic download. Changes in technology through the cloud delivery method are eroding Kentucky's sales tax base. Current sales tax law taxes tangible personal property no matter the method of delivery; prewritten computer software is in the definition of tangible personal property. Increasingly, consumers are moving to accessing computer software on servers owned by Application Software Providers (known as ASPs). This software resides on a server either in Kentucky or outside Kentucky but is accessed by users within the state. As more individual and business consumers move to this method of purchasing prewritten computer software, Kentucky is seeing significant erosion in the tax base. Currently, Kentucky tax code already applies a similar treatment to defined digital property remotely accessed. This proposal allows for the same treatment for the access of prewritten computer software.

**Other states:** A number of states are struggling with eroding tax bases due to cloud-based technology. Several states, such as New York, South Carolina and Utah, have taken action to tax software access on the cloud. "Constructive possession" is a term that has been used in efforts to tax such access. Michigan currently treats these transactions as the sale of software in tangible form and sources based upon the location of the user. Tennessee, whose law is similar to Kentucky in this area, has surveyed states as a part of their review of the subject for possible changes. The state of Washington has done extensive work in this area through collaboration with its home-based tech industries and taxes pre-written computer software accessed electronically regardless of whether charges are based on granting a license, by subscription or on some other basis. Louisiana is currently doing a study on the issue after pulling back from some implementation efforts. Pennsylvania is the latest state to change language of statute to tax the access to software. Ohio taxes software access as a service. Both Indiana and West Virginia also tax prewritten software accessed remotely rather than downloaded. Other neighboring states have not yet passed a change.

**Groups positively and negatively impacted:** Positively impacted - Software vendors which deliver product via download, disk, etc will have equity with competitors that use a cloud platform to provide the same product. Negatively impacted - Those who currently pay no tax by switching to the cloud platform will have to pay their fair share to preserve the tax base attributed to retail sales of prewritten computer software.

**Revenue Score:** Indeterminable increase to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	+

## Proposal # 31: Broaden the sales tax to selected services

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants: "Four rules should guide which services should be considered for taxation:

- The services should be primarily consumed by households.
- Kentucky service producers are not adversely affected in their ability to produce for Kentucky (or out-of-state) consumers.
- The services compete directly with other taxed goods or services.
- Administration and compliance costs are not prohibitively high. These costs are likely to be much lower when applying the tax to goods and services sold by operations already collecting the sales tax on other goods and services they provide."

Multiple states have considered increasing the taxation of services in order to combat fiscal shortfalls. Common justifications also include:

- Streamlining taxation
  - An example...admissions to all sporting events in Kentucky are currently tax exempt, but if we secured an NBA franchise in Louisville, those events would be taxed since they are professional.
  - Remove distortions created by taxing goods only
  - Growing size of the service sector
  - Potential to lower the rate if the base is sufficiently broadened
  - General tax on consumption

### Other states:

#### 25+ States tax these services:

- Short term automobile rental
- Long term automobile lease
- Commercial linen supply
- Service contracts sold at the time of sale of TPP.
- Sign construction and installation
- Software - modifications to canned program
- Trailer parks – overnight
- Billiard parlors
- Bowling alleys
- Cable TV services
- Taxidermy
- Auto service, except repairs, incl. painting & lube
- Automotive rustproofing & undercoating

#### 20+ States tax these services:

- Software
- Direct Satellite TV
- Repair labor, generally
- Labor on radio / TV repairs
- Labor charges - repairs on goods

- Other fuel (including heating oil)
- Diaper service
- Commercial art and graphic design
- Membership fees in private clubs
- Installation charges
- Electricity
- Natural gas
- Health clubs, tanning parlors, etc
- Laundry and dry cleaning services
- Admission to school and college sports events
- Landscaping services
- Typesetting service
- Gift and package wrapping service
- Extermination Services
- Automotive washing and waxing.
- Parking lots & garages
- Labor charges on vehicle repair
- Garment services
- Shoe repair
- Telephone answering service

**15+ States tax these services:**

- Automotive storage
- Carpet and upholstery cleaning
- Maintenance and janitorial services
- Window cleaning
- Automotive road service and towing services
- Pinball and other mechanical amusements
- Pet grooming
- Security services
- Installation charges - other than seller of goods
- Marina Service (docking, storage, cleaning, repair)
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor - repairs to commercial fishing vessels
- Labor - repairs or remodeling of real property

**10+ States tax these services:**

- Mini -storage
- Software services
- Carpentry, building trades

- Household goods storage
- Cold storage
- Funeral services
- Water softening and conditioning
- Credit information, credit bureaus
- Information services
- Gross income of interior contractors
- Exterior construction service (grading, excavating, etc.)
- Water delivery
- Swimming pool cleaning & maintenance
- Coin operated video games
- Fur storage
- Armored car services
- Private investigation (detective) services
- Limousine service (with driver)
- Labor charges on repair of aircraft
- Labor - repairs to commercial fishing vessels
- Labor - repairs or remodeling of real property

**Groups positively and negatively impacted:** Positively impacted would be advocates for increased state revenues. Negatively impacted would be businesses whose services be taxed under this proposal.

**Revenue Score:** +\$176.4 million, if using the services selected by the Report to the Governor's Blue Ribbon Commission on Tax Reform by Economic Consultants.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	-

## **Proposal # 32: Charge sales tax only on materials used to build a manufactured home, or 50 percent of the retail cost**

**Background information:** The retail sale of a manufactured home in Kentucky to be installed in Kentucky is subject to 6% sales tax based upon the total sales price. For financing purposes, the manufactured housing industry typically bundles various components into a single sales price. This can include delivery and set up fees. Therefore, total cost of the home is subject to tax if there are no separately stated charges for various set up fees. Transactions in which a dealer sells a manufactured home including delivery and installation are considered retail sales of tangible personal property. Conversely, the sale of an already installed manufactured home along with related real estate is considered a sale of real property not subject to Kentucky sales tax.

During the 2012 General Assembly, HB 397 was introduced to amend sales tax law (KRS 139.470) to exempt pre-owned manufactured homes and 50% of the sales price of a new manufactured home. This proposal would treat sales of manufactured homes for delivery and use in Kentucky similar to Indiana, Missouri and Virginia treatment. The sale of pre-owned manufactured homes is also exempt in Indiana, Missouri, Ohio and Tennessee.

Similar bills were also introduced in 2000 (HB 767) and 2003 (HB 11). The manufactured housing industry argues that these tax changes will make their products more competitive with traditionally constructed homes. In traditional construction, sales tax is paid by contractors on costs of lumber, concrete, fixtures, etc. that are installed as improvements to real property. The sale of this type of real estate, house and land, is not subject to sales tax. This same exemption applies to a sale of an already installed manufactured home package that includes the lot where the home has been installed.

Industry contends this type of legislative change will make Kentucky manufactured home dealers more competitive with out of state dealers who operate in jurisdictions with different tax laws. However, all dealers must comply with tax laws that apply in a jurisdiction where the home is delivered. For example, a Kentucky dealer that sells and delivers a manufactured home in Ohio must pay applicable Ohio tax to that state. If an Ohio dealer sells and delivers a home in Kentucky, then the dealer must pay Kentucky's 6% tax on the total sales price. Therefore, out of state dealers do not have competitive advantage over Kentucky-based manufacturers because each dealer must comply with tax laws in the jurisdiction where the home is delivered. Furthermore, the sale of pre-owned units in Kentucky is already exempt if a transaction is between private individuals as an occasional sale.

**Other states:** Illinois, like Kentucky, applies sales tax to the full retail sales price of a manufactured home. In Ohio, dealers owe the applicable state and local sales tax based on their purchase price of the manufactured home according to the county in which the purchaser titles the home. The dealer files a use tax return with Ohio when the customer obtains title.

Several border states apply their sales tax on only a portion of the sales price. The tax is based upon a breakdown of price components between tangible personal property and nontaxable labor/services. Indiana requires retailers to collect tax on 65 percent of the selling price, assigning 35 percent to exempt costs other than materials. The selling price includes delivery and set-up. Contractors also pay sales tax on 65% of the invoice price in Ohio. Virginia and Missouri assign 60% of the sales price to tangible personal property/materials. Missouri allows separately stated freight and installation charges, which are deducted from the amount subject to taxation. West Virginia bases the tax on actual cost of materials unless actual cost is not determined. In this case, a 60% designation is allowed.

Tennessee applies one-half the regular sales tax rate to gross receipts or gross proceeds from the retail sale of a manufactured home. In Tennessee, this includes any accessories, parts, furniture, appliances, delivery fees, installation fees or incidental items/services that are part of the manufactured home sale, whether or not billed separately.

**Groups positively and negatively impacted:** Positively impacted - Kentucky manufactured home dealers feel they would be positively impacted by this change. The Department of Revenue feels there is no direct economic activity to be generated from this law change to offset the revenue loss. An argument may be made that more manufactured housing units will be sold, but this argument is debatable and subject to market forces. There are many components factored into the sales price of manufactured housing and any reduction of the sales tax may not benefit individual consumers.

Negatively impacted – county clerks and the Department of Revenue. To the extent Kentucky sales tax is eliminated or reduced on manufactured home sales, county clerks will lose corresponding revenue as they currently keep 3 percent of tax collected as a reimbursement fee. The Department of Revenue also will incur administrative costs to educate affected retailers and buyers and to modify tax systems. Tax compliance will become more difficult if tax is applied on a percentage of the sales price. Even after enacting the proposed law change, differences in tax treatment across state borders must still be accounted for to verify the proper amount of tax in the correct jurisdiction.

**Revenue Score:** For previous legislative proposals, DOR estimated a \$20 million annual loss to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	N	-	-

## Proposal # 33: Exempt business purchases of utility services

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “Business purchases of energy should be relatively easy to exempt without allowing consumers to take advantage of the exemption. The exception is people who live and work in their home. The biggest problems of taxing energy are lessened because energy is exempt for the most intensive users, but the advantages described above would still result.”

**Other states:** Due to the diversity of state taxation of utility services, it is inappropriate to compare this proposal among other states as other jurisdictions may collect similar revenues through a variety of many taxes.

**Groups positively and negatively impacted:** Positively impacted would be business entities that currently pay the six percent sales tax on utilities. Negatively impacted would be advocates for increased state revenue.

**Revenue Score:** -\$124.0 million

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	+

## Proposal # 34: Exempt mail charges for direct mail from sales tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The Streamlined Governing Board has taken many concerns of the direct mail industry under advisement and amended the Streamlined Sales and Use Tax Agreement (SSUTA) accordingly. Some of these changes, now reflected in Kentucky tax code with the term “direct mail” defined in KRS 139.010(10) and sourcing provisions for various categories of direct mail specified in KRS 139.777, provide burden of proof relief for direct mail retailers. The administrative exemption provisions of the SSUTA allow a direct mail vendor to push the tax payment and reporting responsibility to its customers if a certificate is obtained at the time of sale. The industry continues to argue for adoption of additional carve outs available in the SSUTA that provide an exclusion from gross receipts subject to sales tax. Typically the delivery charge is more than the print cost.

Current Kentucky sales tax law applies to any delivery charge to an address in Kentucky. This includes postage costs passed on to the business customer ordering the direct mail. This treatment is the same for any tangible personal property sold at retail that includes a delivery charge. The most recent change in the SSUTA allows member states to choose whether to exclude various component charges for direct mail (postage, delivery and handling) from the definition of gross receipts subject to sales tax. If Kentucky adopts this optional carve out, it will reduce General Fund receipts accordingly.

**Other states:** The border states of Ohio, Indiana, Illinois, Missouri and West Virginia treat these charges in the same manner as Kentucky. Tennessee exempts handling, transportation, shipping and postage charges for direct mail products only; Virginia exempts only postage. A handful of states exempt shipping, handling and postage charges for all tangible products including direct mail. Of the 24 SST Governing Board states, eight states, including Kentucky, treat shipping, handling and postage charges for direct mail as taxable amounts if included in the sales price of printed material. Ten states exclude these referenced charges only for transactions involving direct mail. Two states exclude shipping and postage but not handling charges for all taxable transactions. One state excludes only postage.

**Groups positively and negatively impacted:** Positively impacted - the commercial direct mail industry (in state and out of state entities) that has product delivered to households in Kentucky. Out of state printers selling into Kentucky are required to charge tax on their delivery charges for sales of product into Kentucky in the same manner that resident printers are required to do. Current law does not put Kentucky-based direct mail providers at a disadvantage as all business entities providing both printed material and mailing services must treat product mailed to recipients in Kentucky in the same manner. Household consumers will not be directly impacted because there is no charge to the recipient for direct mail advertising. Negatively impacted – the General Fund.

**Revenue Score:** A decrease in the General Fund between \$1.8 million and \$4.5 million annually depending upon how many of the direct mail components are excluded from the definition of gross receipts (postage, delivery, and handling).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	+

## Proposal # 35: Extend sales tax to the auction price of a thoroughbred horse

**Background Information:** KRS 139.531 addresses application and exemption of sales and use tax to various equine activities. This statute has provided a longstanding exemption (1976) to sales of all horses less than two years of age at time of sale, provided the sale is made to a nonresident of Kentucky and the horse is transported out of state either immediately after the sale or after training in Kentucky. This exemption has been attractive to the horse industry in Kentucky, particularly the annual thoroughbred yearling sales that attract wealthy buyers from other states and from around the world. This proposal would remove the sales tax exemption. This analysis presumes the suggestion is to subject the yearling sales, as well as all other horse auction sales, to the sales tax by removing this exemption.

Changing this longstanding treatment would create a negative reaction from the thoroughbred horse industry. In particular this exemption encourages out of state customers to purchase Kentucky-bred horses. Any legislative proposals perceived to negatively impact this signature industry will be vigorously opposed.

**Other States:** Not many states have a sizable horse industry that rivals Kentucky. Some states do exempt all horse sales, including Texas. New Jersey and Illinois exempt horse sales for breeding purposes.

**Groups Positively and Negatively Impacted:** Positively impacted - the General Fund would increase to the extent yearling sales continued in the same volume post legislation. However, other tax revenue would decline to the extent other economic activity related to horse breeding was curtailed in the state. Negatively impacted - Kentucky-based horse owners, horse farms and horse industry.

**Revenue Score:** In theory, the removal of the yearling exemption from sales tax could represent a \$24 to \$30 million annual increase to the General Fund. However, the compression of corresponding economic activity currently supported by favorable tax treatment must be factored into a net fiscal impact analysis.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## Proposal # 36: Remove the sales tax from livestock antibiotics

**Background information:** Currently the agricultural exemptions for sales and use tax do not include any exemptions for animal health products. Also, a sales tax regulation defines livestock as “animals of a kind the products of which ordinarily constitute food for human consumption.” The regulation also specifies that medicines, vaccines and vitamins are taxable products. This profile assumes the proposal is to broaden the definition of livestock in a similar fashion as proposed in Senate Bill 82 during the 2008 General Assembly (livestock the products of which normally constitute food for human consumption, poultry, equine, farm work stock, ratites, llamas, alpacas, buffalos, aquatic animals and cervids). This profile also assumes the scope of the exemption covers all drugs used in the treatment of livestock whether administered by the farmer, a veterinarian or a third party.

**Other states:** Indiana, West Virginia, Missouri, Illinois, North Carolina have fairly broad exemptions for drugs for animals. Wisconsin exempts drugs for livestock, excluding work stock. Virginia exempts drugs only for animals that constitute food for human consumption. Tennessee and Ohio tax laws are similar to the current treatment in Kentucky.

**Groups positively and negatively impacted:** Positively impacted - livestock farmers (poultry and cattle), the equine industry and veterinarians. Negatively impact - no defined groups are negatively impacted unless a replacement tax is considered to replace the lost revenue.

**Revenue Score:** DOR gave an estimate of \$2 million for a similar proposal in 2008; however, based on past surveys of equine industry expenses, a drug exemption for horses alone represents a \$2 million annual expenditure. The fiscal impact of Wisconsin’s exemption which includes drugs and veterinarian services was estimated at \$8 million for FY 2010. North Carolina’s exemption, which includes feed and litter along with medicine, is estimated at \$85 million (no breakout of these components is available). The exemption for Kentucky represents an expenditure of \$5 million or more annually.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	N	-	N

## Proposal # 37: Implement a back-to-school sales tax holiday

**Background information:** A sales tax holiday is a temporary exemption. Sales tax holidays are usually enacted to assist families during the time just before the start of the school year when school supplies are purchased. However, the sales tax holiday concept has been used in some states in a broader manner to exempt items such as energy star rated products, hunting supplies and firearms. The timeframes of the holidays vary from a single weekend to week long holidays, but all generally impose certain dollar thresholds for purchases to qualify for the exemption.

Bills proposing a sales tax holiday have been introduced each Regular Session of the Kentucky General Assembly for the last six or seven years. 2012 Regular Session House Bills 96 and 101 proposed sales tax holidays.

There are definitely administrative challenges associated with implementation of a sales tax holiday, such as treatment of layaway sales, coupons, rain checks, and returns. The Streamlined Sales Tax Agreement has addressed some of the issues by establishing best practice rules and adopting product definitions that apply specifically to the enactment of holidays.

Research has demonstrated that sales tax holidays do not increase total sales, yet move when the sales occur during the year. The net loss is the tax revenue to the state.

**Other states:** As of July 2012, there are 17 states with a sales tax holiday. This is the same number as in 2011 which is down by two from 2010. Of our surrounding states, Tennessee, Virginia, and Missouri are the only states with a sales tax holiday.

**Groups positively and negatively impacted:** Positively impacted - Retailers are generally supportive of sales tax holidays because they have the opportunity to advertise and increase traffic. These measures are also popular with the general public. Negatively impacted – The Department of Revenue.

**Revenue Score:** For each tax holiday bill proposed in Kentucky, the fiscal impact has been projected to be a net negative fiscal impact.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	-

## Proposal # 38: Impose a gross receipts tax of between 1 and 3 percent on both residential and business utilities

*Note:* This is a proposal from the Consultants to the Commission.

**Background information.** The proposal would impose a 1% gross receipts utility license tax on providers of utilities (residential and commercial). There is already a similar local tax of up to 3% being currently assessed in most jurisdictions whose funding is earmarked for schools.

Economically, utilities are an ideal source of potential revenues due to several underlying conditions:

- The low cost of utilities allows a tax to be imposed without materially affecting the demand for utility services.
- KY does not impose sales tax on residential utilities. Many states already do, so we do have some headroom on this issue on rate setting.
- Utility companies can pass along the small tax increase to the rate-payers (economic incidence)
- By using a utility gross receipts license tax rather than the sales tax, Kentucky would have more flexibility on rate-setting and no conflicts with SSTP.

**Other states:** Approximately 16 states tax residential electricity (including Illinois and Indiana), though in some cases under a special utility tax.

**Groups positively and negatively impacted:** Positively impacted would be advocates for increased state revenue. Negatively impacted would include utilities, utility customers (especially poor utility customers), and industries that consume a large percentage of power.

**Revenue Score:** Each percentage of the tax would result in a fiscal impact approximately \$90 million in extra General Fund receipts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	N

## Proposal # 39: Impose a gross receipts tax of up to 3 percent for residential utilities

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “Residential electricity is exempt from the state sales tax in many states including Kentucky though Kentucky allows the imposition of a utility tax of 3% by local school districts. Imposition of a 3% state gross receipts tax combined with the 3% tax imposed by the vast majority of school districts would make an effective 6% rate, the same as the state sales tax rate. The state tax would presumably be a gross receipts tax (at least in part because the SSTP does not permit multiple tax rates) though it would have the same economic effect as a sales tax. Approximately 16 states tax residential electricity (including Illinois and Indiana), though in some cases under a special utility tax.

Economically, utilities are an ideal source of potential revenues due to several underlying conditions:

- The low cost of utilities allows a tax to be imposed without materially affecting the demand for utility services
- Kentucky does not impose sales tax on residential utilities
- Utility companies can pass along the small tax increase to the rate-payers (economic incidence)
- By using a utility gross receipts license tax rather than the sales tax, Kentucky would have more flexibility on rate-setting and no conflicts with SSTP.
- School tax can be earmarked and touted as a school tax, which brings immediate urgency to consider the overall package of tax reform.

**Other states:** From available information, we could not find any states which impose a gross receipts tax exclusively on residential utilities. By definition, a gross receipts tax on utilities is generally applied to all receipts regardless of the user classification (residential, commercial, etc.).

Tennessee (3%), Ohio (4.65%), Illinois (5%) and Indiana (1.4%) have a state level utility gross receipts tax that applies to all users with limited statutory exemptions. Utilities subject to the tax will vary by state.

**Groups positively and negatively impacted:** Positively impacted would be those who seek increased state revenues. Negatively impacted would be residential utility customers who currently have no state gross receipts tax or state sales tax on their utilities.

**Revenue Score:** \$360.0 million annually

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	-

## Proposal # 40: Impose a sales tax on food for consumption at home

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “The intent of this option is to indicate clearly that consumer goods should be taxed broadly, and mechanisms other than exempting wide categories of goods should be used to achieve vertical equity and other goals. Thirty states exempt food for consumption at home and other states, including North Carolina and Tennessee, tax food at a preferred rate. Food is representative of ongoing efforts in states to exempt consumer goods for a range of different reasons. Tax holidays and clothing are other exemptions that appear to be growing across the states. We believe that Kentucky’s economy will work best if a broad set of goods is taxable at low rates.

Vertical equity, and particularly unfairness for lower income consumers is the traditional argument for exempting food. The purchase of food is regressive in consumption, but so are most other purchases (private education is an exception). So, the sales tax remains regressive even if food is exempt. Further, food stamps are exempt in all states, reducing some of the regressivity of taxing food.

Some have argued that the vertical equity goals could be achieved if food is kept in the base but lower income people are provided a smart card with an amount equal to the annual tax on food or if a credit is provided against the income tax. Alternative options to counteract the additional regressivity imposed by a tax on food include the use of an Earned Income Tax Credit (EITC), significant expansion of the standard deduction in the individual income tax code, or increases in the Family Size Tax Credit.

**Other states:** Indiana and Ohio are the only border states that also exempt grocery food. Tennessee, Illinois, Missouri, Virginia and West Virginia all impose a lower rate on grocery foods. Of these, Tennessee has the highest state rate of 5.25% with additional local rates, Missouri is at 1.225% state rate with additional local rates, Illinois is at 1% with no local rate applied, Virginia with a 1.5% state rate and a 1% across the board local rate applied, and West Virginia is at 2% state rate with no local rate applied.

**Groups positively and negatively impacted:** Positively impacted would be advocates for increase state revenue. Negatively impacted would be households that currently purchase and consume food for home preparation, in particular, low-income households.

**Revenue Score:** +\$484.0 million annually

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	+

## Proposal # 41: 1) Increase collection of out-of-state and Internet sales; 2) Support federal legislation allowing states to require remote firms to collect sales tax

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** For the past eleven years Kentucky and other states have been involved in a multi-state effort to streamline sales and use tax laws to simplify administration, filing and compliance with greater uniformity. Please refer to [www.streamlinedsalestax.org/](http://www.streamlinedsalestax.org/) for more information. Ultimately, the goal is for Congress to enact federal legislation granting states taxing authority over remote vendors. This taxing authority would be given only to states demonstrating a minimum level of simplification and uniformity. There are currently three bills in Congress addressing this issue. Sponsors of two bills are cooperating to develop a single consensus bill--the Marketplace Fairness Act, S.1832, and Marketplace Equity Act, HR.3179.

Since October of 2005, the Streamlined Sales Tax Governing Board has brought in more than \$1 billion in sales and use tax to participating states from voluntary remote vendor collections. This collection figure is significant. However, it is only a small portion of the total annual amount of uncollected sales and use taxes from remote vendor sales.

The opposite side of remote vendor liability is consumer use tax liability on purchases from Internet and other remote vendors. Kentucky, plus 44 states and District of Columbia which impose a sales tax, also have a corresponding use tax directly imposed on purchasers for retail transactions. Kentucky law (KRS 139.310 and 139.330) makes it clear that individual consumers are liable for the 6% tax on their purchase price if the remote vendor does not collect the tax at the point of sale. The Department of Revenue has several ongoing compliance programs to educate and encourage use tax reporting.

In summary, there are several strategies within Kentucky, collectively among states, and before Congress to address state and local Internet sales taxation issues. This is a critical issue for Kentucky-based merchants who directly compete with online merchants for the same customer base and for Kentucky's own tax base.

**Other states:** The current Streamlined Sales Tax Governing Board member states are: Arkansas, Georgia, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Nebraska, Nevada, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming.

**Groups positively and negatively impacted:** Positively impacted – Kentucky-based merchants. Current ecommerce growth patterns indicate that online retail sales will exceed brick and mortar sales by the year 2020. The lack of uniform sales tax treatment of retail sales by remote vendors regardless of the sales channel places Kentucky-based merchants at a distinct disadvantage. When Congress authorizes collection authority to states over remote vendors, competition among retailers will become more equitable. Consumers will have their use tax liability taken care of with collection by the vendor at the point of sale.

Negatively impacted – remote vendors.

**Revenue Score:** Kentucky loses an estimated \$130 to \$200 million annually in uncollected sales and use taxes due to lack of remote vendor collection authority.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity &

				<b>Compliance</b>
+	N	+	+	+

## Proposal # 42: Increase the tax rate on cigarettes and other tobacco products

**Background information:** Excise taxes are often examined as fodder for potential tax reform. Many goods taxed through the excise methodology are considered to be “inelastically demanded”, such that the percentage quantity response to a percentage price change is less than unity in absolute value terms. While border effects can alter the elasticity somewhat as it applies to gross state revenue estimates, modest increases in the tobacco taxes will yield positive revenues and arguably positive health outcomes.

- The Commission has sought information on increasing the tax on cigarettes. Our current rate is 60 cents per pack (plus the sales tax). The proposal outline here is an increase from 60 cents per pack to \$1.00 per pack.
- A similar increase in the ad valorem tax on other tobacco products (OTP) and the excise tax on moist snuff are also being considered.
- Estimates assume an **inventory or floor tax**. Past experience has shown hoarding behavior by consumers. An inventory tax would require any seller of cigarettes to file a floor tax return that includes an inventory of all Kentucky tax stamps in their possession on the effective date of the excise tax increase. Sellers would be required to remit the difference between the new and old rates for every pack of cigarettes in their inventory. States that have failed to enact a floor tax with their excise tax increases have had lower than expected yields due to hoarding packs stamped at the lower rate.

### Other states:

National average: \$1.46 per pack  
Illinois: 98 cents  
Indiana 99.5 cents  
**Kentucky: 60 cents**  
Missouri: 17 cents  
Ohio: \$1.25  
Tennessee: 62 cents  
Virginia: 30 cents  
West Virginia: 55 cents

**Groups positively and negatively impacted:** Positively impacted entities include:

- Advocates for healthier lifestyles through smoking cessation
- Youth advocates, who contend that higher pack prices lead to a more elastic response of young smokers.
- Beneficiaries of the higher tax revenues

Negatively impacted entities include smokers, users of other tobacco products, tobacco wholesalers or retailers that find it difficult to pass wholesale price increase to the consumer, and tobacco growers. The impact on growers would be very minor since the impact of a modest tax increase in one state would not create a large drop in the demand for burley or flue-cured tobacco.

### Revenue Score:

- Raise the Cigarette Tax to \$1.00 per Pack.....\$120.0 Million
- OTP Tax Increase to 22.5 Percent .....\$8.1 Million

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity &

				<b>Compliance</b>
N	-	+	+	N

## Proposal # 43: Raise the sales tax

**Background information:** Kentucky's sales tax rate has been set at 6% since July 1, 1990. The previous rate change was in 1968 when the original 1960 rate of 3% was raised to 5%.

**Other states:** Neighboring states rates are listed below:

Indiana 7%

Illinois 6.25%, but up to 11% with local rates added

Missouri 4.225%, but various local rates can be higher than state rate

Ohio 5.5% with up to 2.25% local rates

Tennessee 7% (5.25% on food) with up to 2.75% local rates

Virginia 4% with additional 1% local tax

West Virginia 6%

**Groups positively and negatively impacted:** Taxpayers will pay additional amounts of sales tax and the General Fund will increase proportionately.

**Revenue Score:** Assuming the sales and use tax base remains the same, each 1% increase generates approximately \$500 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	N

## Proposal # 44: Repeal the distilled spirits case sales tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The distilled spirits case sales tax was enacted long ago and generates very little money, typically less than \$150,000. The other types of alcohol – beer and wine – do not have a similar case sales tax. All other levies on alcohol in Kentucky are uniform across the different types of alcohol beverages. The distilled spirits case sales tax costs approximately \$10,000 to administer.

**Other states:** Other states impose various levies on alcohol, but we could find none that generate such a low amount of receipts as the Kentucky distilled spirits case sales tax.

**Groups positively and negatively impacted:** Positively impacted would be distilled spirits wholesalers. Negatively impacted – unknown.

**Revenue Score:** Loss to the General Fund of approximately \$100,000 per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	N	-	+

## Proposal # 45: Restore Cigarette Rolling Papers Tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** This tax was ruled unconstitutional because it was enacted in the budget process. Until it was repealed, this tax brought in roughly \$750,000 a year. This was prior to the cigarette rolling machine trend that currently is impacting cigarette tax receipts so negatively. The tax could be re-enacted at an increased rate to help compensate for the loss of excise tax to cigarette rolling machines. Another option would be to amend the Other Tobacco Products Tax to include cigarette papers and tubes as Other Tobacco Products at the current 15% rate.

Until it was ruled unconstitutional, this tax was a viable source of revenue for the state. If re-implemented, infrastructure is already in place to collect the tax. The option of including cigarette papers and tubes into the definition of other tobacco products would be easy to implement. The downside of the second option would be lower tax revenues. Any action on this issue should probably be rolled into general tobacco excise tax reform.

**Other states:** Surrounding states have various methods of taxing tobacco products. Several aspects of surrounding states' statutes have been used in developing legislation to close loopholes in Kentucky's statutes. Tennessee taxes little cigars as cigarettes and West Virginia is attempting to treat commercial cigarette making machines at retail locations as manufacturers.

**Groups positively and negatively impacted:** Positively impacted - Kentucky and anyone who benefits from an increase in tax receipts. Negatively impacted - Sellers (resident and nonresident wholesalers) who report the tax and consumers of cigarette papers.

**Revenue Score:** The fiscal impact of this proposal if enacted is an \$800,000 increase to the General Fund in the first year, then \$1 million per year thereafter.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	+	-

## Proposal # 46 Review the sales and use tax on equine products

**Background information:** The equine industry has long been seen as the signature industry of Kentucky. Kentucky's equine industry is comprised of the commercial farms, training centers, show arenas, and race tracks that are engaged in horse-related activities such as breeding, sales, training, racing, showing, boarding, and equine-assisted therapeutic and learning programs. It is imperative to understand that Kentucky's equine industry encompasses more than Thoroughbreds, but includes all horses of all breeds and uses.

The Kentucky Thoroughbred breeding and sales component is considered the strongest in the world with all the infrastructure (stallions, sales facilities, mare management, equine veterinarians, bloodstock agents, transportation services) required to support the industry within a compact geographic area. The significance of this domination of the Thoroughbred industry accounts for the prestige of a Thoroughbred foal bred and born in Kentucky.

The Kentucky horse industry has been facing significant pressure from numerous states that offer significant incentives for the breeding and racing of horses. States with alternative gaming at race tracks are vying for a greater share of Kentucky's equine business. Pennsylvania, Louisiana, Indiana and West Virginia are already attracting Kentucky horsemen. Additionally, new gaming initiatives in New York, Maryland, Florida and Ohio create additional pressure on the Kentucky equine industry with increased purses and breeding incentives.

To help the Kentucky equine industry remain competitive, numerous proposals have been made to expand the sales tax exemptions for the raising of livestock to include equine related agricultural expenditures. Tangible personal property utilized for equine use that could be exempt includes: hay, feed, feed additives, watering systems, equine grooming supplies, straw, seed and fertilizer applied to pastures, etc.

**Groups positively and negatively impacted:** The Kentucky horse industry would be the primary beneficiary of the proposed expansion of the sales tax exemption for tangible personal property for equine use. However, many businesses in Kentucky provide specialized inputs and services to the equine industry, and many of these firms would also benefit from the expansion of the sales tax exemption for equine related tangible property.

**Other states:** Kentucky is in a unique situation where our signature industries include the breeding, training and racing of many horse breed. Few other states place the same priority on their equine industry.

**Revenue score:** Previous proposals have been estimated to have an estimated fiscal impact of approximately \$9.5 million per year.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	-

## PROPERTY TAXES

### Proposal # 47: Allow school districts to maintain the current property tax assessment rate even when the new assessment surpasses the four percent cap

**Background information:** Currently school districts must set property tax rates under the provisions of a collection of statutes known as House Bill 44. If a district wants to set a tax rate that will generate more than a 4% increase in revenues –exclusive of revenue received from new property – that rate is subject to voter recall.

**Other states:** Very limited information was found on how local property tax rates (including school districts) are set in the states surrounding Kentucky. In Illinois, property tax revenues are limited to an increase of the lesser of 5% or the increase in the national Consumer Price Index. In Indiana, the local tax rates are subject to approval by the Indiana General Assembly and tax rates are capped at 1% of value for residential property, 2% of value for farms and 3% of the value of all other real property. In West Virginia, the legislature sets the rate of tax for county boards of education and the school rates have various caps ranging from 22.95 cents per \$100 of assessed valuation to 91.80 cents depending on the type of property and where the property is located i.e. within the city limits or outside of the city. In other states, the tax rates are determined by various boards.

**Groups positively and negatively impacted:** Local school districts would be positively impacted by the removal of the tax rate limitations currently imposed by the provisions of House Bill 44. All real property owners could be negatively impacted by the removal of the property tax rate restrictions.

**Revenue Score:** Unknown. While removing the revenue cap school districts must now work under when adopting property tax rates would make it easier to increase revenues by more than the current 4% limit, there is no guarantee that a school district would do so. There is also no way of knowing how much additional revenue a school district may receive if the current revenue cap is repealed.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	-

## Proposal # 48: Create a tax credit for the bourbon industry to offset the property tax on stored barrels of bourbon, without reducing local property taxes to school districts

### Background: Income tax credits in lieu of barrel tax.

- The distilled spirits industry (especially bourbon) has become a growing signature industry in Kentucky. We have made substantial investments in the Kentucky Bourbon Trail through our Tourism Cabinet.
- Kentucky taxes distilled spirits held in inventory. Specifically, the barrel tax is taxed at the state level as well as full local rates (including school taxes).
- For tax year 2011, local collections were approximately \$12.0 million with an additional \$1.0 in state collections.
- The proposal is to provide a tax credit against the corporation income tax equal to the amount of distilled spirits ad valorem tax (state and local) timely paid in the taxable year, which the industry would reinvest in capital improvements to their facilities.

**Groups positively and negatively impacted:** Positively impacted groups include distillers who store and age bourbon in Kentucky. Distillers will continue to pay the property tax but will receive an income tax credit that equally offsets this liability. Schools and other taxing districts will also win; they will continue to receive the property tax payments and their local distillers will be held harmless to paying the taxes. Groups negatively impacted would include anyone impacted by the loss of General Fund dollars due to the cost of the income tax credit.

**Other States:** Kentucky is in a fairly unique position with a taxation on most tangible property, even though bourbon is a signature industry with very large quantities of distilled spirits being held in storage. When exploring the taxation of other states, details prohibit the analyst from generalizations since each state has a unique mix of local versus state taxes, not to mention different assessment protocols.

**Revenue Score:** \$12.9 million in the first year. The tax should grow over time as the Kentucky distillers presence is preserved.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	N	N	+

## Proposal # 49: Eliminate personal property taxation

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** Currently tangible property is taxed at various rates at the state level with certain classes of tangible property also subject to local taxation. This tax scheme can be confusing for taxpayers with the filing of amended returns happening frequently. The downside to an amended return is that an assessment will be reclassified. Reclassifying takes a return that includes both a state and local tax rate to one with only a state (lower) rate. This can cause severe budget hardships at the local level since tax rates are set based upon the assessments that are initially reported by businesses and any reclassifications typically result in revenue losses. In 1998, the General Assembly proposed an amendment to the Constitution which was ratified by the people at the regular election in November 1998. The amendment allowed the General Assembly to provide by law an exemption for all or any portion of the property tax for any class of personal property (but not real property).

**Other states:** Illinois does not tax personal property. Indiana taxes personal property at both the state and local level. Amended returns must be filed within 12 months of the original filing date. If the amended return is filed between 6 and 12 months of the original filing date, any refund due is reduced by 10%. Missouri, Ohio, Tennessee and West Virginia all tax personal property at the state and local levels. Virginia also taxes personal property but primarily at the local level only.

**Groups positively and negatively impacted:** all taxpayers with personal property (business owners) will benefit from the implementation of this proposal. The state and local property taxing districts will be negatively impacted.

**Revenue Score:** Approximately \$59.8 billion in personal property assessments were reported on tangible returns for the 2011 assessment year. These assessments had the potential to generate \$84.2 million in receipts at the state level. Approximately \$20.2 billion of the personal property assessments were subject to local taxation. Using the 2011 average tax rates for the various local entities the following estimated receipts were generated:

County wide taxing districts - \$75.0 million;  
City taxing districts - \$42.6 million;  
School taxing districts - \$112.8 million; and  
Special taxing districts - \$13.8 million.

The total local impact of eliminating the personal property tax is estimated to be \$244.2 million. Combined with the state loss of \$84.2 million, the total impact would be \$328.4 million.

If this proposal was intended to include motor vehicles and personal watercraft, an additional \$25.3 billion in assessed value would be exempted and the impact at the state level would be an additional \$113.8 million.

Using the 2011 average local tax rates for motor vehicles and boats the following estimated receipts were generated:

County wide taxing districts - \$61.2 million;  
City taxing districts - \$41.2 million;  
School taxing districts - \$140.4 million; and  
Special taxing districts - \$15.7 million.

The total local impact of eliminating the personal property tax on motor vehicles and boats is estimated to be \$258.5 million. Combined with the state loss of \$113.8 million, the total impact would be \$372.3 million. The overall State and local taxing district impact (if motor vehicles and boats are included) would be \$700.7 million.

<b>SCORE ON TAX REFORM PRINCIPLES</b>				
<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
+	+	-	-	+

## Proposal # 50: Exempt Inventory from Property Tax

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** Kentucky taxes several types of inventory under the property tax. Inventory is taxed at different rates. The chart below shows the total assessed value and the amount of state property tax generated from inventory for 2011. There would be an impact upon state and local coffers if inventory were to be totally exempted with the biggest impact upon local revenues.

Description	Assessed Value	State Tax Amount
Manufacturers Raw Materials/Work In Process	7,093,758,225	3,545,559
Motor Vehicles/New Farm Mach/New Boats	2,332,271,553	1,165,229
Unmanufactured Tobacco Products NOT AT PLANT/or in Hands of Grower or His Agent	60,083,891	9,009
Other Unmanufactured Agri Products NOT AT PLANT or in Hands of Grower or His Agent	49,104,068	7,344
Unmanufactured Agri Products At Plant or in Hands of Grower or his Agent/I.R.B.'s	880,313,803	131,979
Aircraft: non-commercial	368,122,702	54,716
Watercraft: non-commercial	95,522,540	13,840
Livestock & Farm Machinery/Fluidized Bed Energy Facilities	1,038,976,860	9,952
Foreign Trade Zone	5,248,668,992	52,451
<b>Totals</b>	<b>17,166,822,634</b>	<b>4,990,079</b>

### Other Inventory with 5¢ state rate + Full local rates

Merchants Inventory	5,710,441,269	2,842,511
Manufacturers Finished Goods	2,035,553,544	1,016,906
Goods Stored in Warehouse	1,120,146,746	559,844
<b>Totals</b>	<b>8,866,141,559</b>	<b>4,419,261</b>

**Other states:** Tangible personal property is exempt in Illinois, Ohio and Virginia. Indiana. Missouri and West Virginia tax tangible personal property at low rates. Tennessee taxes tangible property at various rates.

**Groups positively and negatively impacted:** All businesses within Kentucky would pay less property tax and would be positively impacted. The State and local taxing districts would be negatively impacted.

**Revenue Score:** \$4.4 million annual decrease to state revenues and a large decrease to local tax revenues. Using an estimated total local property tax rate of 120¢/\$100 of assessment, local taxing districts would lose approximately \$ 106.4 million, unless the property tax rates were raised on remaining properties to avoid the loss.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	N	-	+

## Proposal # 51: Freeze the state property tax rate at 12 cents per \$100 of value

*Note:* This is a proposal from the Consultants to the Commission.

### Background information:

- Subsequent to the Special Session of the General Assembly in 1979 and the passage of HB44, the Kentucky tax rate on real property has fallen from 31.5 cents per \$100 in valuation to the 2008 level of 12.2 cents per \$100. Before 2008, there were only two years where the rate did not decline. Since 2008, however, the state ad valorem rate on real property has remained at 12.2 cents for five consecutive years as the housing recession has led to flat or declining property assessments.
- The proposal outlined in the score sheet is to remove the annual rate setting process in favor of an enacted rate of 12 cents per \$100 valuation.
- Over time, as property valuations resume long run growth patterns, the freezing of the rate should enhance elasticity, simplicity, and adequacy.

**Other states:** Kentucky is viewed as a low property tax state, both locally and state rates. A comprehensive analysis of states that allow flexible rates is currently being undertaken.

**Groups positively and negatively impacted:** As time elapses, the fiscal impact will become positive as property assessment re-equilibrate from the Housing Recession of 2007. A few entities would object to any changes in that taxation of real property, most notably the Kentucky Farm Bureau and potential real estate brokers.

**Revenue Score:** Impact will be positive over time.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	+

## **Proposal # 52: Increase funding for PVA offices, or create a dedicated funding stream for PVA offices**

### **Background information**

Property valuation administrator (PVA) offices are funded through a variety of sources. A legislatively approved General Fund appropriation provides the majority of the funding; however, significant revenues are received from the counties and cities as well. Finally, receipts from the sale of data or website subscriptions complete the funding scheme for the PVA office.

The General Fund appropriation from Fiscal Year 2011 of \$36.6 million was reduced to \$34.7 million in Fiscal Year 2012. Although General Fund revenues were increased to \$36.5 million for Fiscal Year 2013, the only way PVA offices have been able to avoid massive layoffs of personnel was to increase the amount of funds received at the local level that are directed to personnel costs, institute mandatory hiring delays when vacancies occur and eliminate some vacant positions. This has left very little money for computer hardware and software upgrades, educational classes, travel for field personnel and even office supplies.

The PVA Association leadership has made numerous presentations to members of the General Assembly's Appropriations and Revenue Committee and, while they have been well received, the financial resources to fully fund each PVA office simply have not been available.

**Other states:** Information is not readily available on how the states surrounding Kentucky fund property tax assessors.

**Groups positively and negatively impacted:** An increase in funding for PVA offices or the establishment of a dedicated revenue stream to fund them would allow PVAs to invest in both personnel and technology that should greatly enhance the accuracy of assessment field work and mapping records that are so essential to maintaining fair and equitable property assessments. It will result in increased revenues for both the State and local taxing districts as newly constructed property will be identified and assessed sooner and more accurately.

**Revenue Score:** Capping the State real property tax rate at 12 cents per \$100 of assessed valuation will eventually allow State revenues to increase by more than the 4% statutory limit currently in place once real property assessments begin increasing at a rate closer to historical rates of 5% to 7%. For the 2012 assessment year, real property assessments totaled approximately \$228 billion; an additional 1% to 3% increase in State real property revenues translates into \$2.3 to \$6.8 million.

Dedicating 1 cent of the State real property tax rate for PVA office funding would provide an estimated \$22.8 million. Since current funding levels exceed this amount, this type of funding option would need to be used in combination with continued General Fund appropriations and local funds.

<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
Not applicable	Not applicable	Not applicable	Not applicable	Not applicable

## Proposal #53: Make private, nonprofit industrial development corporations in purchasing and developing land for business attraction, job creation and capital investment exempt from ad valorem taxes on their real estate holdings

**Background information:** One of the primary goals of Economic Development is the attraction of fixed investment within the Commonwealth. Investment can increase labor force and ultimately tax collections. A chief impediment to this business model is the difficulty in obtaining sufficient funds to develop the underlying infrastructure, a fundamental “must have” for potential investors.

The existing arsenal of economic development tools is, for the most part, adequate to aid the business sector in their pursuits. However, the basic infrastructure needs to be in place before serious investors can evaluate Kentucky as a possible home.

Statewide and local TIF projects are one solution whereby projects can obtain funds for investment. These programs do not return money to the investors until the project is nearly complete and new tax dollars flow in. Since these transactions take up to 3 decades to play out, the proposal above permits more immediate funding to enable ground to break much sooner.

**Other states:** It is very difficult to draw concrete comparisons between and among states due to a variety of funding mechanisms. Proposals for investment pools have become increasingly popular during the last business cycles. Governmental programs have fallen under greater and greater scrutiny to help job creation while simultaneously taking internal budget cuts of their own.

**Groups positively and negatively impacted:** This proposal has impassioned advocates on both sides of the issue. Advocates use a line of reasoning similar in nature to the background above. Detractors to the idea are other property owners that will necessarily pick up the slack for the lost property taxes from the incentives and exemptions. Schools might also lobby against this proposal, to the extent that the exemptions lower the assessed value of properties that pay local city, county, and school rates on their *ad valorem* bills. Again, the properties not getting exemptions will need to pay more as a result of the slight decrease in the local tax base.

**Revenue Score:** Negative impact, probably below \$1 million at the state level. Local taxing districts would be subject to great revenue losses.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	-

## Proposal # 54: Remove the property tax from aviation

**Background information:** This profile assumes the proposal intends to remove the personal property tax from aircraft. If this proposal relates only to aircraft, it is unclear whether the proposal is to remove the property tax from only private aircraft or all aircraft, both private and commercial.

### Other states:

<b>Illinois:</b>	Exempt. Personal aircraft and commercial aircraft are exempt from state & local property tax.
<b>Indiana:</b>	Taxable. Property taxation is essentially local. Commercial passenger aircraft is not subject to Indiana aircraft license excise tax and is exempt from property tax. Airplanes subject to the aircraft excise tax are also exempt.
<b>Missouri:</b>	Taxable. Commercial aircraft is taxable and centrally assessed. Personal aircraft is taxable and locally assessed.
<b>Ohio:</b>	Exempt. Personal aircraft licensed in Ohio is exempt. Aircraft would be assessed in the municipal corporation or county in which the owner resides. Beginning in tax year 2011, all tangible personal property of general (non-public utility) taxpayers is exempt from taxation.
<b>Tennessee:</b>	Personal aircraft is exempt from property taxation. Commercial aircraft is taxable for property taxation. Commercial aircraft used for general business purposes are assessed and are subject to local taxation. Commercial aircraft used for passenger and freight transportation are assessed on an apportioned basis at the state level. No state tax imposed.
<b>Virginia:</b>	Taxable. Generally, subject to local taxation only and may not be taxed by the state. Commercial aircraft used in interstate commerce is apportioned to Virginia on miles traveled in the state.
<b>West Virginia:</b>	Taxable. Subject to state and local tax.

**Groups positively and negatively impacted:** Positively impacted – owners of aircraft. Negatively impacted - local taxing districts if all non-commercial and commercial aircraft are exempt from property taxation. The General Fund will also be negatively impacted for commercial aircraft. The state revenue loss of \$54,700 for non-commercial aircraft would be negligible.

### Revenue Score:

Private/Non-Commercial Aircraft: In 2011, non-commercial aircraft was assessed at \$368,122,700 for all counties. Using an estimated local rate of 120¢/\$100 of assessment, this generated an estimated \$ 2,576,900 in total revenues for all local taxing districts. The state revenue generated was \$ 54,716. The state tax rate is 1.5¢/\$100 of assessment.

Commercial Aircraft: In 2010, commercial aircraft was assessed at \$ 751,385,800 for all counties. Using estimated local rates of 90¢/\$100 of assessment for personal property, and the 4R multiplier of 51% applied to personal property assessments, this generated an estimated \$3,488,900 in total revenues for all local taxing districts. Using the state 4R rate of 22.82¢/100 of assessment this generated an estimated \$ 1,714,700 in total state revenues.

<b>SCORE ON TAX REFORM PRINCIPLES</b>				
<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
N	+	N	-	+

## Proposal # 55: Identification of public service companies for taxation

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Adopting this proposal expands Kentucky's public service company tax code to include newly developing utility industries operating within Kentucky and to clarify the intent of the overall statute. Deregulation of industries and technological advances have spawned new types of companies that should be recognized as public service companies, which are subject to assessment by the Department of Revenue.

New companies to be added to public service company taxation include those generating power via wind, solar or other means. Also included are power marketing companies for any form of energy.

### Other states:

**Illinois:** Exempt. Commercial solar/wind electric generating companies are exempt from state & local personal property tax. Real property is taxable.

**Indiana:** Taxable. Property taxation is essentially a local issue. Commercial solar / wind electric generating companies are subject to property taxation.

**Missouri:** Taxable. Commercial solar / wind electric generating companies are taxable and centrally assessed.

**Ohio:** Taxable. Commercial solar / wind electric generating companies are taxable as utilities and centrally assessed.

**Tennessee:** Taxable. Commercial solar / wind electric generating companies are subject to property taxation, centrally.

**Virginia:** Taxable.

**West Virginia:** Taxable. Commercial solar / wind electric generating companies are centrally assessed as a utility and subject to state and local taxation.

**Groups positively and negatively impacted:** Positively impacted - state and local tax revenues. Negatively impacted - newly developing utility industries that will be subject to property tax.

**Revenue Score:** Unknown increase to state and local property tax revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	-	+	N

## Proposal # 56: Reporting the rental space for documented watercraft/private airplanes

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Owners who rent space for mobile homes and out-of-state RVs are required to file an annual report with the PVA. This proposal would extend that requirement to those who rent space for documented watercraft and private airplanes. This would help to guarantee that documented watercraft and private aircraft are subject to ad valorem taxes.

**Other states:** Surrounding states handle the reporting and taxation of documented boats and private aircraft in different ways, with some exempting personal property completely.

**Groups positively and negatively impacted:** Positively impacted - local taxing districts and the state because reporting of documented boats and private aircraft would lead to greater compliance and more revenue even if tax rates are kept the same. Negatively impacted - owners of documented watercraft and private airplanes who rent space in Kentucky for that type of property.

**Revenue Score:** The fiscal impact is hard to determine because it would mean putting a dollar amount to an unknown (i.e., the total value of documented boats and private aircraft that are not reported).

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	+

## **Proposal # 57: Amend the Constitution to eliminate the homestead exemption for those over 65 while putting in place a statutory means-tested property tax circuit breaker for those over 65**

**Background information:** If the homestead exemption is eliminated for homeowners 65 and older that would affect 336, 525 property owners and would add \$10.9 billion in assessed value to the real property tax rolls. Unless there would be accompanying legislation that would allow this increase to be treated as “new property” in the initial year, the state real property tax rate would be reduced to limit any revenue increase to the statutory 4% limit.

A property tax circuit breaker typically represents a refund or credit to property owners whose property tax payments are deemed too big of a percentage of their household income. These programs vary tremendously between states and even local taxing jurisdictions.

### **Other states:**

Illinois – no State property tax. All real property is subject to local taxation. An exemption for homeowners with household incomes of less than \$100,000 is available. The maximum exemption is \$20,000. Counties can implement different exemption values up to the maximum. Homeowners at least 65 years of age are eligible for a homestead exemption that reduces the equalized assessed value of their home up to \$4,000.

Indiana – Taxpayers are entitled to a deduction from the assessed value of the person’s homestead in the amount of the lesser of 60% of the assessed value of the home or \$45,000. There is also a circuit breaker credit against excessive property tax liability. This is defined as tax liabilities in excess of 1% of a homestead’s gross assessed value. No age or income limits were found to be imposed on this deduction or credit.

Missouri – A circuit breaker credit of up to \$1,100 of property taxes paid or rent constituting property taxes for Missouri residents 65 or older is available. This credit is also available for claimants at least 60 years old if he or she is receiving surviving spouse social security benefits. Claimant income must not exceed \$30,000. There is also a homestead exemption credit for homeowners at least 65 years of age for an increase in their property taxes that exceeds 5% in a reassessment year or 2.5% in a year without a general reassessment. An applicant’s income cannot exceed \$77,323. If the applicant is married he or she must be at least 65 years of age and the spouse must be at least 60 years old or disabled.

Ohio – A homestead exemption applies to the first \$25,000 in assessed value of property used as a home for property owners aged 65 and older.

Tennessee – A local option property tax freeze is authorized for homeowners 65 or older. An income limit of the greater of the weighted average of the median household income for the age groups 65 – 74 and 75 and older in the county or the applicable state tax relief income limit under Tennessee law is imposed. Homeowners who are at least 65 years of age who meet certain income requirements are also entitled to a credit or reimbursement of a portion of the property taxes paid on their homes.

Virginia – There is a local option to enact a program for exemption or deferral for property taxes on homes owned and occupied by a person at least 65 years old. Local governments may also impose income or financial worth limitations

West Virginia – The first \$20,000 in assessed value is exempted for property owners at least 65 years of age on their personal residence. There is also a program that allows low income, elderly homeowners to receive a

credit of up to \$125 of property taxes paid on their homesteads or the percentage of the rent paid that is deemed to be attributable to property taxes.

**Groups positively and negatively impacted:** Positively impacted – local property tax revenues. Negatively impacted - homeowners with household incomes over whatever threshold is established.

**Revenue Score:** State property tax revenues would not change unless legislation is enacted that would allow this increase in assessed value to be treated as “new property” in the initial year. Otherwise, the state real property tax rate would be reduced to limit any revenue increase to the statutory 4% limit. Local taxing districts, like the state, would be impacted positively if the assessment amount gained by removing the homestead exemption was treated as “new property.” If the increase in assessed value was not treated as “new property,” under HB 44, most local taxing districts would still be limited to a rate that would generate a 4% gain in revenue. Any local rate adjustment above the 4% limit is subject to voter recall.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	N	-

## Proposal # 58: Remove the HB44 recall provisions for local and school real property taxes

**Background information:** Under the series of statutes collectively known as “House Bill 44,” local taxing districts cannot set a real property tax rate that will produce more than a 4% increase in revenue – exclusive of revenue received from new property – without first having a public hearing and then going through a 45 day period during which a taxpayer recall petition may be filed. If a petition is filed, the taxing district has the option of adopting a tax rate that will provide a 4% increase in revenues. However, if the taxing district wants to continue in its efforts to set a rate that will produce more than a 4% increase in revenues, the rate is put to a vote at the next election.

**Other states:** Very limited information was found on how local property tax rates are set in the states surrounding Kentucky. In Illinois, property tax revenues are limited to an increase of the lesser of 5% or the increase in the national Consumer Price Index. In Indiana, the local tax rates are subject to approval by the Indiana General Assembly and tax rates are capped at 1% of value for residential property, 2% of value for farms and 3% of the value of all other real property. West Virginia has maximum local tax rates established by law. In the other states the local tax rates are determined by various boards and commissions.

**Groups positively and negatively impacted:** Positively impacted - local and school taxing districts would be positively impacted by the removal of the tax rate limitations currently imposed upon them; however, there would likely continue to be enormous pressure on these districts to keep property tax rates in check. Negatively impacted - all real property owners could be negatively impacted by the removal of the property tax rate restrictions.

**Revenue Score:** Unknown. While removing the recall provisions for local and school property tax rates definitely would make it easier to raise these tax rates, there is no guarantee that the districts would do so. There is also no way of knowing how high a district may raise a tax rate.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	-

## SEVERANCE TAXES

### Proposal # 59: Eliminate the export credit under the minerals severance tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Current law allows a 100% credit against the gross value of exported limestone if a taxpayer exports 60% or more of the limestone severed in Kentucky. Those who sever Kentucky limestone and sell more than 40% to Kentucky-based customers are at a disadvantage compared with those who export the majority of minerals severed.

During the fiscal year ending June 30, 2011, more than \$2.2 million in credit was claimed.

**Other states:**

**West Virginia:** Rate is \$5.00 per \$100 with no export credit given. There is an allowable credit for companies engaged in business activities of the reporting period. The credit is \$500 yearly or \$41.67 monthly and does not relate to exports.

**Tennessee:** A tax is levied upon the severance of mineral products from the earth and readied for sale. However, sales of all minerals for use outside Tennessee are exempt. Exempt sales do not need to be included in this return, but records must be maintained to support the exemption.

**Groups positively and negatively impacted:** Positively impacted - Counties that receive minerals severance tax receipts. Negatively impacted- Limestone companies that would no longer have the credit available.

**Revenue Score:** Eliminating the credit will increase General Fund revenues and increase the amounts allocated to counties with limestone mines. In FY2011, the amount of credit claimed was \$2,224,700.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## Proposal # 60: Raise the rate on the Coal Severance Tax

**Background information:** The current severance tax rate on coal severed or processed in this state is 4.5% of gross sales. The amount of severance tax received is split evenly between the General Fund and the fiscal court of the county where the coal was severed.

**Other states:** Information was found about two of the seven states surrounding Kentucky:

West Virginia: WV Rate: \$5.00 per \$100 No export credit given.

Allowable Credit: There is an allowable credit for companies engaged in business activities of the reporting period. This credit doesn't relate to exports. The credit is \$500 yearly or \$41.67 monthly.

Tennessee: A tax is levied upon the severance of mineral products from the earth and ready for sale. Also sales of all minerals for use outside the State of Tennessee are exempt. Exempt sales do not need to be included in this return; however, records must be maintained to support the exemption.

**Groups positively and negatively impacted:** Positively impacted - if the severance tax rate of 4.5% is raised, the state's General Fund and fiscal courts will see an increase in severance tax receipts. Negatively impacted - coal companies and coal processors will see a negative impact from having to pay more severance tax.

**Revenue Score:** Total coal severance tax receipts for fiscal year ending 6/30/2012 were \$298,068,048 at 4.5%. At 5% the amount would have been \$331,178,297 for every increase of ½ percent, receipts would increase by \$33,117,829 more before anything was returned to the counties. Below are examples of the revenue received, before being split between the state and local fiscal courts.

5% = \$ 331,178,297

5.5% = \$ 364,305,392

6% = \$ 397,424,064

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	-	+	+	+

## Proposal # 61: Clarify the definition of “gross value” under severance tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Coal severance tax and minerals severance tax is imposed on the severing or processing of coal or minerals. In the definition of “gross value” for computing the tax base, the reference to section 613(c) of the Internal Revenue Code needs to be removed from the severance tax statutes. The statutes state that “gross value” is synonymous with gross income from property as defined in section 613(c) of the Internal Revenue Code. Under the federal statute, gross income from property in this context means gross income from mining. The federal statute does not consider processing to be gross income from mining unless performed by an owner or operator of a mine. An argument can be made that processing performed by anyone else is not taxable because the amount of gross income from mining is zero, and thus, the amount of gross value will always be zero.

If no change is made, current coal severance taxpayers who are engaged in processing coal that they do not mine themselves may argue that their severance tax liability is zero.

**Other states:** For severance tax definitions, no surrounding state was found to include a reference to the internal revenue code as Kentucky does.

**Groups positively and negatively impacted:** Positively impacted – counties that receive severance tax funds. Negatively impacted – processors of coal and minerals in Kentucky who are not the owner/operator of the mine may argue that they are not subject to the tax.

**Revenue Score:** A receipts reduction of approximately \$3,200,000 in state revenues and \$3,200,000 in local revenues will occur on an annual basis if the definition is not clarified.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## OTHER TAXES / ISSUES

### Proposal # 62: Eliminate Tax Increment Financing programs (TIFs)

**Background information:** Tax Increment Financing (TIF) is a tool to use future gains in taxes to finance the current improvements that will create those gains. When a public project is carried out, there is an increase in the value of surrounding real estate, and often new investment (new or rehabilitated buildings, for example). This increased site value and investment creates increases in values of taxable properties and taxable activities, which increases tax revenues. The increased tax revenues are the "tax increment." Tax Increment Financing dedicates that increased revenue to finance debt issued to pay for the public infrastructure of the project. TIF is designed to channel funding toward the public improvements in distressed or underdeveloped areas where development would not otherwise occur. TIF creates funding for public projects that may otherwise be unaffordable to localities.

The first step for all programs is the establishment of a TIF development area by a city, a county, or one of the eligible agencies identified in statute as eligible. The statutes authorize two types of TIF development areas. A development area on vacant land is eligible for local participation only. A development area which includes a developed area in need of redevelopment or other blight conditions may be eligible for both state and local participation. There are three separate state participation programs available, each of which has its own distinct requirements for eligibility.

In considering the elimination of the TIF program, one must be cognizant of the fact that all current TIF projects are contractually guaranteed the tax incentives for which they qualified. Any elimination of the TIF program would only impact future potential recipients; and thus, any potential savings would not occur in the short-term.

Furthermore, the tax incentive projects must demonstrate at their onset that they provide a net positive impact to the Commonwealth. As such, the potential long-term savings of eliminating the TIF program would be encompassed by a net negative fiscal impact of those projects that will not be undertaken without TIF incentives.

The Commonwealth of Kentucky uses TIF incentives to attract qualified businesses and development projects to the Commonwealth. The Economic Development Cabinet would be placed at a disadvantage relative to competitor states if the TIF program were to be eliminated.

**Other states:** Forty-nine (49) states and the District of Columbia have statutes that provide for tax increment financing. Most of these states allow only sales tax and property tax to be included in the tax increments. Kentucky is the only state that allows income tax to be included in the tax increments. California terminated tax increment financing, effective February 1, 2012, as part of their massive budget cuts.

**Groups positively and negatively impacted:** Businesses and corporations of the magnitude that would apply for TIF incentives spend months, if not years, compiling information and planning projects. Without the TIF program the businesses or developers may very well choose not to move forward with their project in Kentucky.

#### Revenue Score:

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	+

## Proposal # 63: Establish a Kentucky estate tax with modest exemption limits

**Background information:** Kentucky's current estate tax is coupled with the federal state death tax credit. The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) of 2001 repealed the federal estate tax for deaths occurring after 12/31/09. However, the federal law changed Kentucky's estate tax receipts much sooner. The federal state death tax credit, upon which the Kentucky estate tax is based, was repealed for estates of decedents who died after 12/31/04 and replaced by a deduction. Thus, Kentucky's estate tax was effectively repealed for estates of decedents who died after 12/31/04. Current federal estate tax law will sunset on 12/31/12 if Congress does not act to extend the repeal. If no Congressional action is taken, the federal estate tax law in effect prior to 2001 will become effective for deaths occurring on or after 1/1/13. No Congressional action also means that the current dormant Kentucky estate tax would become active again. If Congress does act, it could preserve the current federal system which results in Kentucky's estate tax remaining dormant.

Other states have frozen their reference to the federal law based on a previous version of the federal law that still maintains the credit computation. States that have made this change still require the federal form to be completed that was in use as of the date chosen to freeze the reference. Due to differences between the exemptions in the federal law and Kentucky law, it would be more practical to modify Kentucky's existing estate tax independent of federal law. A stand alone tax could replace the former estate tax that mimics the previous base without requiring federal forms to be completed. This would restore revenues at levels prior to the change. The calculation would reduce the net estate, as currently calculated for Kentucky's inheritance tax, by the distributions to a spouse and charities. The rates used to compute the state death tax credit could then be applied to this figure to determine the Kentucky estate tax. As before, a credit would be given for any inheritance tax due. The proposed revised estate tax would only apply to estates in excess of \$ 3,500,000.

Below is the receipts history for the combined inheritance and estate taxes for a fifteen year period illustrating the impact of the federal law change.

FY 2012	41,312,904
FY 2011	41,350,928
FY 2010	37,201,611
FY 2009	41,234,239
FY 2008	51,001,299
FY 2007	43,578,106
FY 2006	45,990,266
FY 2005	63,174,865
FY 2004	66,083,705
FY 2003	95,864,480
FY 2002	83,359,871
FY 2001	83,461,499
FY 2000	74,489,980
FY 1999	81,483,083
FY 1998	105,538,129

As the above numbers reflect, the repeal of the state death tax credit greatly impacted Kentucky's receipts, particularly for fiscal years 2006 forward. Previous studies by the Department of Revenue on the combined inheritance and estate tax receipts resulted in an approximate estate tax percentage of 40 – 50% of the total.

**Other states:** Illinois reinstated its estate tax in 2011 by referencing the 2001 federal law and setting its own exemption amount. Indiana and Tennessee are still tied to the federal law like Kentucky is, but both are phasing out its inheritance tax by 2021 and 2016 respectively. Ohio created a stand-alone tax, but repealed it effective

January 1, 2012. Missouri, Virginia and West Virginia are still tied to the federal law and do not have an inheritance tax.

At least 25 states (including Ky.) have their estate tax statutes in “hibernation” depending on what happens at the federal level.

At least 19 states have “de-coupled” from the 2001 federal law change to preserve the estate tax computation that was in effect under the Internal Revenue Code of 12/31/00. Some states in this category have created their own version of a stand-alone estate tax but even in those cases, the laws appear to model the mechanics of the pre-2001 federal tax.

**Groups positively and negatively impacted:** Positively impacted would be the General Fund. Negatively impacted would be estates that currently benefit from the effect of the current federal estate tax law and the inapplicability of the Kentucky estate tax law.

**Revenue Score:** \$10 million increase to the General Fund in the first year. \$18 million increase in yrs. 2 & 3.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	-

## Proposal # 64: Impose the Pari-mutuel tax on advance deposit wagers made by Kentucky residents on live races conducted at Kentucky race tracks

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Kentucky residents currently can place a wager on horse racing via internet gambling sites without the wager being taxed under the pari-mutuel excise tax. The resident establishes an account with an entity that provides the opportunity to wager via the internet. The resident places money in the account (advance deposits) from which wagers are made. This modern type of wagering on horse racing has become more popular and enables the gambler to wager and watch from home as opposed to betting at a race track or simulcast facility. Wagers made via this modern method on live racing conducted at Kentucky race tracks is reducing the wagering handle on live racing that is the tax base for determining the amount subject to pari-mutuel tax on live racing; technology is eroding the tax base. Therefore, the Department of Revenue proposes to tax advance deposit wagers in a similar fashion as wagers made at licensed race tracks on live racing. DOR proposes a rate of one-half of one percent (.005)

**Other states:** Illinois taxes advance deposit wagers at 1.5%.

**Groups positively and negatively impacted:** Groups positively impacted – The equine groups that receive funds from pari-mutuel excise tax collected on live racing. Groups negatively impacted – Possibly tracks that conduct live racing if the advance deposit wagers push the total live wagering handle to an amount over \$1.2 million

**Revenue Score:** Approximately \$2 million per year in additional pari-mutuel tax revenues are projected.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## Proposal # 65: Sunset or provide regular review of tax incentives

**Background information:** The Commonwealth of Kentucky offers numerous business incentives to provide a competitive, pro-business climate to attract and retain businesses. The Kentucky Economic Development Finance Authority (KEDFA), established within the Cabinet for Economic Development to encourage economic development, business expansion, and job creation, provides financial support through an array of financial assistance and tax credit programs. Helping businesses in this way furthers the Commonwealth's goals of achieving long-term economic growth and employment opportunities for its citizens.

Kentucky's economic development incentive toolbox was further enhanced when Governor Steve Beshear signed into law House Bill 3, known as Incentives for the New Kentucky (INK), in June 2009, streamlining and modernizing Kentucky's business incentive programs. The landmark legislation revamps key existing programs, while also creating several new programs to further encourage new investment and job creation in the Commonwealth. One of those programs is the Kentucky Small Business Investment Credit (KSBIC) program, the first tax credit program of its kind for small businesses in Kentucky.

In considering the sun setting of the numerous and diverse economic development incentives, one must be cognizant of the fact that all current projects receiving incentives are contractually guaranteed the tax incentives for which they qualified. Any elimination of the incentive programs would only impact future potential recipients; and thus, any potential savings would not occur in the short-term.

Furthermore, the tax incentive projects must demonstrate at their onset that they provide a net positive impact to the Commonwealth. The Commonwealth of Kentucky uses tax incentives to attract qualified businesses and development projects to the Commonwealth.

**Groups positively and negatively impacted:** Businesses and corporations of the magnitude that would apply for the incentives available spend months, if not years, compiling information and planning projects. By placing a sunset provision the developers cannot be assured the incentive will be available when the time arrives to apply. Without that assurance the developer may very well choose not to move forward with their project in Kentucky.

**Other states:** Several states have some type of sunset provision for their tax incentive programs. The following are some examples of sunset provisions:

- Illinois has a provision that a credit program must have a sunset date or it will automatically expire in 5 years.
- The Arkansas Equity Investment Incentive law provides that the credit is set to expire on December 31, 2028.
- The Rhode Island I-195 redevelopment district life sciences jobs incentives program sunsets on December 31, 2021.

The following are some examples of a regular review of tax incentives:

- Iowa - Effective July 1, 2010, a legislative tax expenditure committee is created to annually review Iowa tax incentive programs.
- Oklahoma law provides an Incentive Review Committee to perform an annual comprehensive review of state tax incentives.

**Revenue Score:** Not applicable.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	+	+	-

## Proposal # 66: Broaden the hospital provider tax to include doctors

**Background information:** In general, a "provider tax," sometimes termed a "fee" or "assessment," is a state law that authorizes collecting revenue from specified categories of providers. In most states, it is used as a mechanism to generate new in-state funds and match them with federal funds so that the state gets additional federal Medicaid dollars. In a majority of cases, the cost of the tax is promised back to providers through an increase in the Medicaid reimbursement rate for their patient treatment and services. Beyond Medicaid, states have the policy option to tax most types of providers and services and to designate or earmark the revenue for any state purpose.

Under federal law and regulations, a state's ability to use provider-specific taxes to fund their state share of Medicaid expenditures has limits. Those taxes cannot generally exceed 25% of the state (or non-federal) share of Medicaid expenditures and the state cannot provide a guarantee to the providers that the taxes will be returned to them. Despite these federal limitations, many states are now using or considering use of provider taxes, sometimes to supplement static or declining provider reimbursement rates. In part, this is aided by a federally-defined "hold harmless" rule — if the taxes returned to a provider are less than 6 percent of the provider's net patient revenues, the prohibition on guaranteeing the return of tax funds is not violated. As a result, a state may be able to impose a provider tax (up to 5.5% of revenues between January 2008 through September 2011), return some or all of those revenues directly or indirectly back to those providers in the form of a Medicaid 'payment' and receive a federal match for those amounts. States can use that revenue to increase payments to providers for services to Medicaid patients but those payments must be consistent with the hold harmless rules at 1903(w) which state that payments cannot guarantee repayment of a tax directly or indirectly.

In the Commonwealth, physicians, pharmacies, and HMOs were exempted from the provider tax in 1999. In the prior fiscal years, the revenues associated with the physicians subject to the provider tax were approximately \$35 million per year, on average. Pharmacies and HMOs represented approximately \$14 million per year, collectively.

However, any inclusion of physician services in the provider tax would also require legislative changes to the current cap on total tax collections under the provider tax. Provider taxes were capped at \$180 million by House Bill 244 in the 2007 Regular Session.

**Other states:** There are no states that impose a provider tax on physicians' services. The last to try was West Virginia, and this provision was repealed as of July 1, 2010. All border states have a provider tax and most impose the tax upon hospitals and nursing home facilities in addition to other classifications. However, Indiana, Tennessee and Virginia have the narrowest provider tax bases which exclude hospitals. Missouri's provider tax is the only border state which includes retail pharmacy receipts.

**Groups positively and negatively impacted:** It would be anticipated that physicians and associated providers would strongly object to a reversal in provider taxing policy.

**Revenue Score:** In the early to mid 1990's, Kentucky had a provider tax on physicians at the rate of 2.0 percent. The tax peaked in FY96 at a level of \$44.3 million. Today a 2% provider tax would be at least \$100 million in total receipts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	-

## ROAD FUND ISSUES

### Proposal # 67: Implement a trade-in credit for new car purchases

**Background information:** Kentucky's motor vehicle usage tax is collected by county clerks when a vehicle is presented for registration. Unlike used vehicles, the retail price for new vehicles is not reduced by the amount of the vehicle(s) given in trade. Tax is based on total consideration given as attested to in a notarized affidavit or 90% of the MSRP if an affidavit is not available.

Legislation passed in 2009 allowed trade-in credit on new vehicles until June 30, 2011 or until a \$25 million cap is reached. The legislation was effective September 1, 2009 with the cap being reached on August 16, 2010. During implementation of the temporary credit, changes were made to the automated vehicle information system to track when the cap was reached. That computer system is being replaced by a new vehicle information system and a permanent trade-in credit allowance would require modifications to that new system.

**Other states:** In most states vehicles are subject to sales and use tax. Missouri, Illinois, Indiana, and Ohio all allow trade-in deductions on new vehicles.

**Groups positively and negatively impacted:** Positively impacted - new motor vehicle dealers and taxpayers who purchase a new vehicle and have a trade-in. Negatively impacted – the Road Fund.

**Revenue Score:** Based upon the temporary credit experience, there could be a minimum annual \$25 million decrease to the Road Fund. On average, the Road Fund decreased \$672.20 each time a vehicle was traded in on a new vehicle.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	-	-	-

## Proposal # 68: Raise the floor for fuels taxes

Freeze the statutory lower bound on the average wholesale price definition used in the calculation on the tax rate on motor fuels.

### Background information:

- The gasoline tax in Kentucky is comprised of three components:
  - A variable rate, which is 9.0% of the Average Wholesale price (AWP is defined in statute). The AWP floor or minimum rate is currently set in statute at \$1.786 per gallon, so 9% of that equals 16.1 cents per gallon.
  - A Supplemental Highway Tax of a flat 5 cents per gallon on gasoline and 2 cents per gallon on special fuel.
  - An Underground Storage Fee of 1.4 cents per gallon.
  - All three taxes are paid at the wholesale level, but the taxes are ultimately passed to consumers at the pump. (Incidence of the tax at consumer level)
- The Variable Rate component of the fuels tax has risen in each of the last 5 years as average wholesale prices have risen.
- By statute (KRS 138.210), the average wholesale price is limited to 10% growth per year. That equates to roughly a maximum tax rate increase of 1.5 cents per year (first increase was exactly a penny).
- The first two increases in the statutory AWP were memorialized in statute.
  - In 2005, the statutory floor was raised to \$1.22
  - In 2006, the statutory floor was raised to \$1.34
- The proposal here is to freeze the minimum AWP at \$2.616 per gallon (current fiscal year rate)
- Falling fuel prices could destabilize Road Fund since the tax rate on motor fuels is tied to the average wholesale price of motor fuels. See KRS 138.210 (10).
  - AWP for purposes of setting the fuels rate is limited to a 10% annual increase.
  - There is no 10% cap on reducing the AWP
- In both the 2005 and 2006 legislative actions, the extra “pennies” of fuels tax preserved by the law changes were designated as “unshared”, with the end result being 2.1 cents of our fuels tax not being shared with locals.

**Other states:** Most states tax motor fuels. Most states have a mechanism that dictates a process for future rate changes. The idiosyncrasy in the KY rate formula is that we have a 10% cap on increases but no 10% stop loss for reductions. This asymmetry seems rather unique, and changing the process to eliminate the idiosyncrasy would remove considerable risks on longer term construction projects that require adequate revenue in the future.

**Groups positively and negatively impacted:** Virtually all groups support road construction would support this measure. Kentuckians for Better Transportation highlighted this in their recommendations at the Fayette meeting. Opponents will be few at the moment as there will be no fiscal impact on this proposal for several years.

**Revenue Score:** No fiscal impact in the short run. Will help establish a workable base in the longer term.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	+

## Proposal # 69: Reduce dealer's compensation on motor fuels tax from 2.25% to 1%

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Kentucky's motor fuels taxes are collected by licensed dealers. Dealers are allowed a compensation allowance that reduces the amount paid each month to Kentucky. This allowance compensates for dealers' expenses incurred for collecting and remitting the tax. Kentucky licensed motor fuel dealers receive a much higher compensation compared to surrounding states as well as the state vendor/wholesaler population at large. In many states a licensed dealer is required to share the compensation with retail gasoline vendors. In Kentucky no such sharing provision exists. Currently the entire 2.25% compensation is retained by licensed dealers. Also of note, licensed dealers have until the 25th day of the following month to remit tax to Kentucky via monthly returns. This return due date provides float time of considerable value to licensed dealers. Because of technology advances, most motor fuels taxes are collected electronically before the fuel tanker leaves the terminal. This practically eliminates bad debt claims.

The current dealer compensation rate has not been adjusted to reflect these changes in technology that make reporting and filing compliance easier. Since 2008, the Department of Revenue has provided a web-based electronic filing and payment system to the dealer community. Training and implementation of the system was provided at no charge to dealers.

As a comparison, Kentucky has made legislative changes to the vendor compensation for sales and use tax. Prior to July 1, 1990 the sales tax vendor compensation was two percent. Since July 1, 1990 the compensation rate has been 1.75% of the first \$1,000 in tax (\$17.50) and 1% of collections above \$1,000. An overall cap per reporting period of \$1,500 was initially set in place through the 2003 Budget Bill. The \$1,500 cap was continued in two additional budget bills and was permanently codified in 2008. The sales and use tax vendor compensation cap has generated an estimated \$9.5 million increase to the General Fund.

**Other states:** Missouri allows 3.1% on gasoline and 2.1% on special fuels, but the supplier must pass on either 3% or 2%, respectively, to the distributor/retailer. Ohio has reduced its rates by 50% whereby dealers now get 1% instead of 2% they received in 1998. Virginia has reduced its previous 0.5% exemption to 0.005% and now gives a 1% allowance to licensed distributors and importers. Indiana allows 1.6% and Tennessee compensation is 1%.

**Groups positively and negatively impacted:** Positively impacted would be all who participate in and rely upon sound road infrastructure throughout Kentucky. Negatively impacted would be licensed gasoline and special fuel dealers (wholesalers).

**Revenue Score:** \$17.5 million increase to the Road Fund in the first year. \$21,000,000 increase in yrs. 2 & 3.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	-	+	+	N

## Proposal # 70: Modify the index in the gas tax rate to tie it to the inflation rate of transportation infrastructure construction costs

### Background:

- The gasoline tax in Kentucky is comprised of three components:
  - A variable rate, which currently stands at 23.5 ¢ per gallon of fuel.
  - A Supplemental Highway Tax of a flat 5 cents per gallon.
  - An Underground Storage Fee of 1.4 cents per gallon.
- The Variable Rate component of the fuels tax has risen in each of the last 5 years as average wholesale fuel prices have risen.
- By statute (KRS 138.210), the average wholesale price is limited to 10% growth per year. That equates to roughly a maximum tax rate increase of 1.5 cents per year (first increase was exactly a penny).
- The first two increases in the statutory AWP were memorialized in statute.
  - In 2005, the statutory floor was raised to \$1.22
  - In 2006, the statutory floor was raised to \$1.34
- The proposal profiled in this document does the following:
  - Freeze the variable fuels tax at the current excise rate of 23.5¢ per gallon
  - Starting on July 1, 2012, the variable rate would increase
    - No longer use 9% of the AWP
    - Use the inflation rate for road construction.
    - The new rate would be constant until the next July, where the rate would go either up or down depending upon fuels cpi.
- Falling fuel prices could destabilize Road Fund since the tax rate on motor fuels is tied to the average wholesale price of motor fuels. Fuels are the single-largest revenue source to the Road Fund.
- As the chart demonstrates below, the CPI measure for transportation goods has grown faster than all cpi, but has not kept pace with the current statutory average annual rate increase of over 7 percent per year.

	CPI	% chg	CPI-TRANS	% chg
FY99	164.6		141.6	
FY00	169.3	2.9	149.4	5.5
FY01	175.1	3.4	155.2	3.9
FY02	178.2	1.8	151.9	-2.1
FY03	182.1	2.2	156.2	2.8
FY04	186.1	2.2	159.3	2.0
FY05	191.7	3.0	167.0	4.9
FY06	198.9	3.8	179.9	7.7
FY07	204.1	2.6	181.2	0.7
FY08	211.7	3.7	192.7	6.4
FY09	214.7	1.4	182.6	-5.2
FY10	216.8	1.0	189.0	3.5
FY11	221.1	2.0	202.8	7.3
FY12	227.6	2.9	215.5	6.2

**Other States:** Surprisingly, escalators in the tax per gallon have taken different forms. No single “best state practices” emerged. We’ll continue to dig deeper with a complete border analysis if this option gathers widespread support.

**Groups positively and negatively impacted:** Positively impacted groups would be road fund contractors, who would have a steady increase in fuels tax receipts to stabilize the growth in the road fund. No groups would have a negative impact per se, as in some years inflation would be greater or lesser than the actual change in average wholesale fuel prices.

**Revenue Score:** The initial fiscal impact (to the Road Fund) will be negative. FY14 is currently projected to have the maximum 10% increase in the average wholesale price of fuel. That corresponds to about 8 percentage points in growth over FY13. Growth in Transportation CPI is projected to be about 6.7%. Summary is a negative fiscal impact in the very short run.

In the moderate term, we get about the same revenues but with much lower risk. The only way to get a decline in the fuels rate under this proposal is to see falling CPI. In the longer run (five years out or further), this proposal would be a net positive on the scorecard with the added benefit of a hedge against volatility on the cut side.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	-	-	-	-

## LOCAL TAXATION ISSUES

### Proposal # 71: Allow all classes of local governments to have a local option food and beverage tax

**Background information:** Imposing a local option sales or excise tax on food and beverages requires an amendment to Section 181 of the Kentucky Constitution.

Kentucky's current sales and use tax exemption for food items under KRS 139.485 has been in effect since 1972. Many states have a similar exemption primarily to relieve the tax burden on lower income residents who spend a relatively large portion of their income on grocery food. As a part of the national effort under the Streamlined Sales and Use Tax Agreement (SSUTA), Kentucky has adopted uniform definitions of food and food ingredients and agreed to remain in compliance with other uniformity changes governing how local jurisdictions impose sales taxes. For example, this local tax would have to be centrally administered and collected and conform with the uniform food and food ingredient definitions that apply to food and beverages. There would be additional administrative burden and expense for the Department of Revenue to take on these administrative, collection and distribution responsibilities.

**Other states:** Indiana is the only border state that also exempts grocery food. Ohio and West Virginia tax food at the general sales tax rate. Tennessee, Illinois, Missouri and Virginia all impose a lower rate on grocery foods. Tennessee is highest at 5.25%, Missouri at 1.225%, Illinois at 1%, and Virginia at 1.5% state rate and 1% local rate.

**Groups positively and negatively impacted:** The localities receiving funds for the imposition of this tax are positively impacted. Residents who no longer benefit from the full exemption on food and food ingredients incur a negative impact.

**Revenue Score:** The current tax expenditure rating for food for human consumption is nearly \$470 million annually at the current 6% sales tax rate. An across the board 1% in all localities could generate \$78 million annually.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	Not applicable	Not applicable	Not applicable	-

## Proposal # 72: Amend the Constitution to allow a local general sales tax

*Note:* This is a proposal from the Consultants to the Commission.

**Background information:** “From the Report to the Governor’s Blue Ribbon Commission on Tax Reform by Economic Consultants: “The ability of local governments to use a general sales tax will give them more flexibility and stability in their revenue collections. However, for a number of reasons the state must impose some limitations and constraints on the imposition of local sales taxes”.

- First, the local general sales tax must be collected by the state and it must be imposed on the same base. Independent collection would be costly and lead to significant problems with compliance. These criteria also follow the Streamline Sales and use Tax Agreement to which Kentucky is a full participating member.
- Second, another concern is the pyramiding of tax collections by having different local governments within an area— for example, counties, municipalities, and school districts in the same area --- using different general sales tax rates. Collections by the state will significantly reduce the administrative concerns regarding multiple local entities but situsing the sales across local governments and multiple tax rate will increase the complexity for businesses and state tax collectors.
- A third consideration is what locality receives the tax revenue. Tax revenue will be collected at the point of sale but as much as possible our recommendation is that receipt of tax revenue be destination not source based. Thus if a good is ordered in one municipality but shipped elsewhere the tax revenue should be credited to the municipality where the good is shipped and presumably consumed. True destination taxation will only occur with goods that are shipped since the tax will be paid where possession of an item is taken if a person drives to a store in another county and takes possession in the other county.

The state will need to impose limits on the rates that local governments can set. As discussed previously, a local sales tax will reduce state tax collections by decreasing sales in the state. This will be a particular concern for localities on state borders – high local sales taxes in these areas can be expected to reduce retail revenues and associated state tax revenues. Use of the sales tax by multiple types of local governments only compounds these concerns about the interdependent tax bases and the associated impacts on revenues.

Finally, it should be mentioned that a local option sale tax (LOST) requires a constitutional amendment. The Supreme Court has held that under Ky. Const. § 181 the General Assembly cannot delegate the power to levy excise taxes such as sales and use taxes to subordinate units of government such as cities and counties *IC.C.C. Coal Co., Inc. v. Pike County*, 536 S.W.2d 467 (Ky. 1976)).”

**Other states:** Thirty-eight states allow a local general sales tax. Tennessee and Illinois allow a local general sales tax only. Ohio, Virginia and Missouri allow both local sales and local income taxes.

**Groups positively and negatively impacted:** Advocates for increased local government funding would be positively impacted. Negatively impacted would be anyone who purchases items under the local option sales tax.

**Revenue Score:** -\$10 million per year.

<b>SCORE ON TAX REFORM PRINCIPLES</b>				
<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
-	-	-	-	-

## Proposal # 73: Switch to a statewide restaurant tax of one percent instead of localities having different restaurant taxes

**Background information:** KRS 91A.400 authorizes some local governments (fourth and fifth class cities) to impose a tax up to 3 percent on restaurants, which is given to the tourist and convention committee established in that city. A statewide one percent tax rate would standardize both the application and the applied rate as a simplification measure. Expanding qualifying localities beyond fourth and fifth class cities will substantially increase applicability. If administration of this statewide tax falls within the purview of the Department of Revenue, further analysis of costs will be needed. The analysis must include the scale of distribution of funds collected. Within its current budget, the Department will not be able to absorb development, operation and maintenance of a statewide restaurant tax.

**Other states:** Each surrounding state allows imposition of a local restaurant tax, primarily on a county by county basis. The allowable rates are usually between 1 and 3.5 percent. Virginia is the only border state that imposes a statewide local rate of 1 percent.

**Groups positively and negatively impacted:** Positively impacted are the additional localities and agencies receiving funds from this tax. Negatively impacted are all restaurant patrons in areas not previously taxed and localities previously leveling a higher rate.

**Revenue Score:** Restaurant tax collections for 2012 in Kentucky totaled \$11.2 million. An across the board 1% tax in all localities could be expected to produce \$45 million or more annually. In addition, to the extent restaurants pass the tax onto their patrons, these additional charges will be considered gross receipts subject to 6% state sales tax.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	Not applicable	Not applicable	Not applicable

## Proposal # 74: Allow single sales factor apportionment as a defined option to the city/county business tax calculation

**Background information:** Currently, a city, county or special district apportions taxable income using a two factor formula of sales and payroll. The use of a single sales factor apportionment would create winners and losers.

The Department of Revenue does not have any legal authority over the occupational license tax imposed by cities, counties and special districts. Each city, county or special district administers its occupational license tax as provided by KRS 67.750 to 67.790.

**Other states:** Most surrounding states do not have occupational license taxes or an equivalent. Ohio has a city and county income tax and a three factor formula of sales, property and payroll to apportion income.

**Groups positively and negatively impacted:** Positively impacted – businesses that will use the single factor method to pay less income tax at the local level. Negatively impacted – Local jurisdictions that impose a business income tax if the net result of this proposal is a reduction in receipts. The impact on tax revenue cannot be determined, but some taxpayers will pay more tax and some will pay less tax.

**Revenue Score:** A decrease in local tax revenues will occur in those jurisdictions that impose an occupational tax on a business' gross profits.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
-	+	-	-	+

## Proposal # 75: Eliminate or limit (1%) occupational tax for counties less than 30,000

**Background information:** Currently, each city, county or special district has its own rate for the occupational tax established by its governing body.

The Department of Revenue does not have any legal authority over the occupational license tax imposed by cities, counties and special districts. Each city, county or special district administers its occupational license tax as provided by KRS 67.750 to 67.790.

**Other states:** Most surrounding states do not have occupational license taxes or equivalent. Ohio has a city income tax but has no limit on the tax rate that a city may establish.

**Groups positively and negatively impacted:** Positively impacted – taxpayers who would pay less occupational tax. Negatively impacted – local governments that depend on occupational tax revenues in those counties whose population is less than 30,000.

**Revenue Score:** Unknown decrease in local tax revenues for those counties with a population of less than 30,000 that impose an occupational tax.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	-	-	-

## SIMPLICITY, COMPLIANCE AND TAX ADMINISTRATION

### Proposal # 76: Allow non-renewal of professional licenses, driver's licenses and vehicle registration if taxpayers are delinquent on state taxes to improve collections

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The Department of Revenue seeks to enact the following legislation:

- 1) Requires agencies, boards and commissions to deny the issuance of a license to an applicant when a delinquent tax debt exists to Kentucky based upon a Department of Revenue request;
- 2) Gives the Department of Revenue authority to revoke a Kentucky driver's license for the collection of delinquent tax debt. This includes motor vehicles, motorcycles, commercial driver's licenses, etc.; and,
- 3) Gives the Department of Revenue authority to work cooperatively with county clerks to deny issuance of a vehicle registration to any taxpayer who has an unpaid delinquent tax liability.

The Department of Revenue plans to use these methods only in instances where the taxpayer has due and payable (delinquent) tax debt, has not entered into satisfactory repayment arrangements, and/or is not currently in bankruptcy. The Department of Revenue's intent is to use these methods to encourage voluntary compliance. Taxpayers who are making a concerted effort to pay would be exempt. Taxpayers who contact the Department of Revenue and make satisfactory repayment arrangements would be released from denial/revocation. Revocations would be used only in instances where there had been a license denial and release because the taxpayer promised to pay, but failed to do so.

#### Other states:

- 1) **Professional License Denial/Revocation Programs** - Delaware, Hawaii, Illinois, Indiana, Iowa, Kansas, Maine, Maryland, Massachusetts, Minnesota, Missouri, New Jersey, North Carolina, Oklahoma, Oregon, Pennsylvania, Rhode Island, Vermont, and Wisconsin.
- 2) **Vehicle Registration Denial:** Massachusetts and Rhode Island
- 3) **Drivers License Denial/Revocation:** Massachusetts and Rhode Island

\*Note: Massachusetts and Rhode Island combined their Vehicle Registration and Drivers License programs.

**Groups positively and negatively impacted:** Positively impacted - Proponents of increased General Fund collections. Negatively impacted - Taxpayers who refuse to pay.

#### Revenue Score:

The projected fiscal impact of this proposal, if enacted, is as follows:

- 1) **Professional License Denial/Revocation** - \$250,000 General Fund increase in first full year of implementation, \$2.9 million the second year.
- 2) **Drivers License Denial/Revocation** - \$1.5 million in year two. A full year will need to be dedicated to system development. This will need to be a cooperative effort with county clerks, other state agencies including Kentucky State Police, and perhaps the Transportation Cabinet.
- 3) **Vehicle Registration Denial** - \$1.5 million in year two. At least a full year needs to be dedicated to system development. This project needs to be a cooperative effort with county clerks and the Transportation Cabinet.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

## Proposal # 77: Amend tobacco tax laws to provide clarifications and administrative improvements enabling the Department of Revenue to better enforce Kentucky tobacco tax laws

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The proposed changes will include licensing requirements updates; other administrative reporting updates; and clarifications regarding sales of other tobacco products by out of state manufacturers/distributors into Kentucky. Also, clarification in regard to commercial cigarette making machines and market inequities caused by disparities in federal tax rates on “roll your own” tobacco, etc.

**Other states:** Surrounding states have various methods of taxing tobacco products. Several aspects of surrounding states’ statutes have been used in developing legislation to close loopholes in Kentucky’s statutes. Tennessee taxes little cigars as cigarettes. West Virginia is attempting to treat commercial cigarette making machines at retail locations as manufacturers.

**Groups positively and negatively impacted:** Positively impacted -Kentucky and resident cigarette and other tobacco products wholesalers. Negatively impacted – Out of state premium cigar interests and out of state cigarette and other tobacco products wholesalers.

**Revenue Score:** An increase to the General Fund of up to \$3 million per year can occur.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

**Proposal # 78: Apply statute of limitations evenly to both assessments and refund claims. In particular, claims for refund based on constitutional challenges should not be singled out for discriminatory treatment by shortening the statute of limitations. Extend the number of days to protest an assessment to at least 60 days, preferably 90 days**

**Background information:** There is a two year difference in statute of limitations for refunds to a taxpayer based on unconstitutional findings. This time difference was to reduce the likelihood of a catastrophic reduction in receipts as a result of refunds. This reasoning also applies to assessments made by the Department of Revenue as it is barred from collecting or assessing a resulting tax based upon the unconstitutional issue.

**Other states:** The statute of limitations for assessments and refunds in other states varies between 2 – 4 years.

**Groups positively and negatively impacted:** Positively impacted - Taxpayers would be positively impacted by the change by having more tax periods eligible for refunds. Negatively impacted – the General Fund and Road Fund.

**Revenue Score:** An unknown reduction to the General Fund and Road Fund will occur.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	-	-	N

## Proposal # 79: Clarify the definition of “pollution control facilities” under tangible personal property tax statutes

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Adopting this proposal will **simplify** Kentucky’s tax code by clarifying key terms that will clearly state that real property is subject to state and local property tax rates, which prevents pollution control facilities from claiming a lower tax rate.

The Department of Revenue seeks to clarify that for a “pollution control facility,” ONLY tangible personal property is taxable at a state rate of 15¢/\$100 of assessed value. It also is exempt from local taxation for ad valorem purposes. If this proposal is not enacted, there is a potential General Fund loss of \$1,000,000.

### Other states:

- Indiana:** Certified pollution control facilities are exempt. Illinois Certified pollution control facilities (real property) are assessed at the fair cash value of their economic productivity to the owners.
- Missouri:** Pollution control equipment assessed at 25% of fair cash value. Commercial real property assessed at 32% of fair cash value.
- Ohio:** Facilities for the control of air, noise, and water pollution are exempt.
- Tennessee:** Facilities valued at their "salvage value," commencing January 1 of the year following the date of application for certification.
- West Virginia:** Facilities placed into operation after July 1973 are valued for property tax purposes at their "salvage value." This is defined as the price for which the facility would sell in place if voluntarily offered for sale by the owner.
- Virginia:** Localities are required to exempt certified pollution control equipment along with facilities placed in service on or after July 1, 2006. Beginning January 1, 2011 all such equipment and facilities, excluding land, are exempt, regardless of the date placed in service.

**Groups positively and negatively impacted:** Positively impacted - Local taxing districts. Negatively impacted - Privately-owned contained solid waste landfills.

**Revenue Score:** If enacted, this proposal will prevent a loss to the General Fund of \$1 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	N	+

## Proposal # 80: Create a uniform occupational tax statewide form

**Background information:** The Department of Revenue does not have any legal authority over the occupational tax imposed by cities, counties or special districts. Each city, county or special district administers its occupational tax as provided by KRS 67.750 to 67.790 resulting in more than 250 different forms.

House Bill 277 of the 2012 Regular Session was enacted and provides that the Secretary of State shall prescribe a standard occupational tax form or forms, through the promulgation of an administrative regulation, which shall be accepted by all tax districts. However a district can opt out. The standard form or forms are required to be adopted by administrative regulation prior to July 1, 2017.

Since the new law does not require the uniform form until 2017, perhaps the proposer is seeking legislation to achieve an earlier effective date for a uniform occupational license tax form.

**Other states:** Most surrounding states do not have occupational taxes or an equivalent. Ohio has a city and county income tax but does not have a uniform form for all jurisdictions.

**Groups positively and negatively impacted:** Groups positively impacted - taxpayers and their CPA's. Groups negatively impacted – unknown, but there may be local jurisdictions imposing occupational taxes that wish to keep their current forms.

**Revenue Score:** Unknown

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	Not applicable	Not applicable	Not applicable	+

## Proposal # 81: Define the terms “broadcast” and “telephonic equipment” in the tangible personal property tax statutes

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Adopting this proposal will **simplify** Kentucky’s tax code by clarifying key terms.

There is not a current statutory definition of “broadcast” or “telephonic equipment”, although there is one in case law. Potential fiscal impact of an adverse court decision is noteworthy, with a possible loss of \$1,500,000 in state revenue, and \$4,000,000 in local revenue.

### Other states:

**Indiana:** Locally assessed and taxed.

**Illinois:** All personal property is exempt from property taxation.

**Missouri:** Commercial personal property equipment assessed at 33.33% of fair cash value. Telecommunication companies are assessed centrally by the state tax commission. The state rate is 3 cents per \$100.

**Ohio:** Tax on telecommunication equipment was phased out beginning January 2010.

**Tennessee:** Centrally assessed as a public utility property for local tax only. There is no state rate.

**West Virginia:** Centrally assessed as a public utility property.

**Virginia:** Centrally assessed for local tax only. There is no state rate.

**Groups positively and negatively impacted:** Positively impacted - Local taxing districts.

Negatively impacted - Wireless (cellular) telephone companies & satellite communication service providers.

**Revenue Score:** The proposal intends to save the loss of \$1,500,000 in state revenue, and \$4,000,000 in local revenue.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	N	+

## Proposal # 82: Eliminate negligible state property tax rates for tangible personal property.

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Kentucky tax rates for some personal property items are extremely low. Prior to 1998, tangible personal property could not be exempted from tax based on Kentucky Constitutional requirements. As a result, some personal property items were taxed at minimal state rates. A constitutional change, passed in 1998, gave the General Assembly authority to eliminate classes of personal property from taxation. The Department of Revenue proposes to eliminate state taxation on the following classes of property:

- Unmanufactured Agriculture Products in Holding (1.5 cents per \$100)
- Non-commercial Aircraft/Watercraft (1.5 cents per \$100)
- Foreign Trade Zone property (One-tenth of one cent per \$100)
- Livestock & Farm Machinery in fluidized Beds Energy Facilities (One-tenth of one cent per \$100)
- Manufacturer's Raw Materials, Goods in Process, Motor Vehicles held for Sale, Farm Machinery held for Sale, Salvaged Title Vehicles (5 cents per \$100)

**Other states:** Tangible personal property is exempt in Illinois, Ohio and Virginia. Indiana, Missouri and West Virginia tax tangible personal property at low rates. Tennessee taxes tangible property at various rates.

**Groups positively and negatively impacted:** Positively impacted - CPAs and taxpayers who want simplification and consistency. Negatively impacted - Those taxpayers who will still pay tax on other types of tangible personal property.

**Revenue Score:** Negative \$5 million to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	-	-	+

## **Proposal # 83: Eliminate the need for paper Form K-1E, Kentucky Employer's Return of Income Tax Withheld.**

**Background information:** Currently, employers must file a paper Form K-1E with the Department of Revenue. It has been recommended that businesses should be allowed to file Form K-1E electronically, which would expedite the filing process for both taxpayers and Department of Revenue.

The Department of Revenue is currently developing an electronic filing system for Form K-1E. This form should be available for electronic submission prior to December 31, 2013.

**Other states:** The surrounding states that impose individual income tax have payroll withholding reports that can be filed electronically.

**Groups positively and negatively impacted:** Positively impacted - Filing Form K-1E electronically would benefit both taxpayers and Department of Revenue. Negatively impacted – none.

**Revenue Score:** Unknown. There will be a small cost to add this form to the electronic filing platform.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	+	N	N	+

## **Proposal # 84: Eliminate the requirement forcing taxpayers to file a bond prior to appeal to Circuit Court. Extend the number of days to protest an assessment to at least 60 days and preferably 90 days**

**Background information:** At the time the appeal is made to the Circuit Court, the case has been reviewed and an order issued by the Kentucky Board of Tax Appeals upholding the final ruling of the Department of Revenue. In other words, the tax is “due and owing.” Any delay in payment only lengthens the time the taxpayer has to pay the bill. This delay could result in a long drawn out process in which the ability of the taxpayer to pay the bill may diminish. The bond assures that the proper amount of tax will be paid unless the ruling is overturned.

This bond requirement is consistent with Federal tax appeals guidelines. Only in cases of “extraordinary circumstances” is a bond not required at the federal level in the appeal process.

The current protest period is 45 days. When compared to other states with longer protest periods, the current statute allows a more generous extension. Should the protest timeframe increase, the Department of Revenue suggests a requirement that the supporting statement be submitted at the same time or a policy similar to other states regarding extensions for filing a supporting statement.

**Other states:** There are numerous other states including Florida, Texas, Indiana and Illinois that have similar bonding requirements.

Regarding protest periods, the Internal Revenue Service currently requires taxpayers to protest within 30-days of receiving notice. The protest periods for surrounding states are:

Ohio	60 days
Indiana	60 days
Illinois	60 days
Missouri	60 days
Tennessee	30 days
Virginia	90 days
West Virginia	60 days

All of the states that have a longer protest period require more supporting information to be provided without an extension or with a shorter extension period than that provided by Kentucky.

**Groups positively and negatively impacted:** Positively impacted – taxpayers that appeal a ruling of the Board of Tax Appeals to Circuit Court. Also, taxpayers would be positively impacted by the additional time to file a protest. Negatively impacted – the General Fund and Road Fund.

**Revenue Score:** An unknown reduction to General Fund and Road Fund receipts will result from elimination of the bond requirement. In terms of extending the number of days to protest, there would be a negative impact of approximately \$12 million in the year of implementation as the change will also postpone the enforcement collection period which will diminish collectability over time. Any change to the existing statute regarding refunds/assessments based on constitutional challenges could have an extraordinary negative impact to receipts.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	-	-	-

## Proposal # 85: Give multijurisdictional taxpayers a minimum of 180 days to report changes on a prior federal return at the state and local level

**Background information:** Current state income tax law provides that a taxpayer shall submit a copy of the final determination of a federal income tax audit to the Department of Revenue within 30 days of the federal audit's conclusion. An identical requirement exists in Kentucky's local occupational tax statutes.

**Other states:** Most states do not have a time limit for taxpayers to submit copies of completed federal income tax audits. Their laws provide that the statute of limitations does not begin until an amended tax return is received.

The time limit for taxpayers to submit copies of completed federal income tax audits to local jurisdictions in other states is unknown.

**Groups positively and negatively impacted:** Positively impacted - this proposal would benefit multijurisdictional taxpayers as they would have additional time to file amended Kentucky income tax and local occupational tax returns to reflect federal audit adjustments. Negatively impacted – the General Fund and local occupational tax receipts. Extending the date to submit a copy of the final determination of a federal audit may delay the collection of taxes.

**Revenue Score:** An unknown decrease to the General Fund and local occupational tax receipts will result if tax collections are delayed. Interest would accrue during the extended period for state taxes.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	-	N

## Proposal # 86: Installment payment agreement clarification

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The Department of Revenue proposes to amend the taxpayer bill of rights to clarify the exact parameters of an “installment agreement.” This proposal also will establish the Department of Revenue as the final authority concerning terms of any installment payment agreement. Some taxpayers interpret current language as a means to slow down the collections process. Those taxpayers pay a smaller monthly amount rather than the amount stipulated by the department under a payment agreement.

The current statute infers that taxpayers are entitled to a payment agreement and can set their own terms. Amending the statute will provide the Department of Revenue the ability to grant a payment agreement and to regulate minimum payments based on a taxpayer’s ability to repay.

**Other states:** No border state has this provision in their statutes.

**Groups positively and negatively impacted:** Positively impacted – General Fund. Negatively impacted – Taxpayers who try to slow down the collections process by paying a smaller amount instead of the monthly amount stipulated by the department.

**Revenue Score:** Minimal

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
Not applicable	Not applicable	Not applicable	+	+

## Proposal # 87: Make LLC members personally responsible for all taxes & make corporate officers personally liable for motor vehicle usage tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** This proposal is needed to assist in collecting delinquent taxes in cases where the LLC business entity form is used to create uncollectible delinquent tax liabilities. LLC member personal liability already exists for some taxes including sales and withholding. This proposal seeks to obtain that authority for all taxes. This proposal also is needed to assist with compliance on Kentucky residents who seek to avoid payment of motor vehicle usage tax on their purchase of RV's. They do this by creating LLCs and titling the vehicles in the state of Montana. There is a nationwide scheme among some RV owners to avoid proper payment of tax.

**Other states:** Other states have LLC member personal liability for delinquent taxes mostly for trust fund taxes. A "trust fund tax" means the business at issue is not the ultimate payer of the tax and merely collects the tax from a third-party for the state. Indiana has successfully litigated and held LLC members liable for their tax on RVs registered under "Montana LLCs".

**Groups positively and negatively impacted:** Positively impacted – Groups interested in enhanced General Fund and Road Fund receipts. Negatively impacted – Anyone who hides behind the LLC form of business to avoid paying Kentucky taxes.

**Revenue Score:** Indeterminable but a General Fund increase of more than \$10 million is possible.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	+	+	+

## Proposal # 88: Repeal the Rural Electric Cooperative Corporation & Rural Telephone Cooperative Corporation Tax (one tax)

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The Rural Electric Cooperative Corporation and Rural Telephone Cooperative Corporation Tax are “in lieu” of taxes which are \$10 per year for each entity. It costs the Department of Revenue more to process the remittances than the revenues generated. Fiscal Year 2011 receipts totaled \$310.

**Other states:** Other states have special levies for a variety of purposes but it is unknown if any states have an identical tax to this one.

**Groups positively and negatively impacted:** Positively impacted would be the Commonwealth due to elimination of inefficiencies and focus on more value-added activity. Negatively impacted – none.

**Revenue Score:** A net gain of \$25,000 due to efficiency savings.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
Not applicable	Not applicable	Not applicable	Not applicable	+

## Proposal # 89: Review the disparity in the tax code and law between *documented* and *undocumented* boats

**Background information:** In order to eliminate the disparity between the state property tax rate for *documented* boats (1.5¢/\$100 of assessment) and registered boats (45¢/\$100) of assessment, all boats must be taxed at the same state rate.

Prior to 1999 all owners paid the full state tax rate of .45¢ per \$100.00 of assessed value of their boat. In 1998, HB 588 effective 1/1/99, lowered the property tax rate to 1.5¢ per \$100 of assessed value on certain federally documented vessels. These vessels are not in the business of transporting people or property for hire or other commercial purposes. HB 588 also allowed local governments and taxing districts to exempt these same vessels from local property tax.

### Other states:

**Indiana:** Indiana levies and collects a Boat Excise Tax. The amount of the excise tax depends on the age and value of the watercraft when it was new, according to the current boat class tax schedule. Motorboat and sailboat excise taxes range from \$2 to \$500, depending on the boat's class. The excise tax is reduced annually but the reduction will never exceed 50 percent of the boat's original tax value. The excise tax for stored motorboats and sailboats is \$12 annually.

**Ohio:** Property tax on watercraft is assessed and taxed at the local level. Different rates apply for each county.

**Illinois:** Illinois does not tax personal property.

**Tennessee:** Property tax on boats is assessed and collected at the local level. Different rates apply for each county.

**Virginia:** Boats are assessed and taxed at the local level.

**Missouri:** Boats are assessed and taxed at the local level.

**Groups positively and negatively impacted:** The impact depends on the option selected. There will be winners and losers among affected taxpayers. The General Fund will be negatively impacted if the state rate is reduced or eliminated. If a local option to exempt all boats is passed, local governments could be negatively impacted if the option is exercised.

**Revenue Score:** Unknown because several options exist which could increase or decrease state property tax revenues.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	Not applicable	Not applicable	Not applicable	+

## Proposal # 90: Sales tax successor liability to enhance the Department of Revenue's collection efforts

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Revenue proposes to amend sales tax law to bolster the intended legislative purpose of the statute. Currently the statute refers to “Purchase Price” as the standard for withholding delinquent sales tax from the seller of a business. Revenue proposes a language change to “Fair Market Value,” which will eliminate potential transfer of property without withholding unpaid sales tax.

This proposal should alleviate the need for litigation, provide clear guidance and expedite the collection of delinquent sales tax due on the sale of a business.

**Other states:** No border state has this provision in their statutes.

**Groups positively and negatively impacted:** Positively impacted - Taxpayers who pay the correct amount of sales tax due from the sale of their business. Negatively impacted - Those who attempt to avoid paying delinquent sales tax upon the sale of their business.

**Revenue Score:** Minimal increase to the General Fund.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	Not applicable	+	+	+

**Proposal # 91: Under the tangible personal property tax statutes, clarify that inventory-in-transit must be delivered to a permanent out-of-state destination in order to qualify for the under 6 month exclusion**

*Note:* This is a proposal from the Department of Revenue.

**Background information:** This proposal intends to prevent the loss of state and local revenues by preventing claims that tangible personal property sent out of state temporarily is exempt from taxation.

Taxpayers are claiming no personal property tax is owed for inventory that leaves the state within six months then returns at a later date. We believe this was not the intent of the legislation. By clarifying “destination” in the statute as “the place where an item of tangible property is sent permanently” this would prevent similar claims in the future that could result in the potential loss of ad valorem revenues for the state and local taxing districts.

The consultants to the Commission listed eliminating the inventory tax as an option and that proposal, if adopted eliminates the need for this proposal.

**Other states:** Our border states exempt inventory in transit with Virginia’s exemption applying only to property in a free trade zone.

**Groups positively and negatively impacted:** Positively impacted - Local taxing districts.  
Negatively impacted - Companies that lease tangible personal property to out-of-state locations.

**Revenue Score:** There is no way to know what property currently classified as “Inventory” will be claimed to be “Inventory-in-Transit” in the future if no change is made. By making this change, future loss of revenue will be prevented.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	N	N	+	+

## Proposal # 92: Use tax notification and compliance requirements for remote vendors

*Note:* This is a proposal from the Department of Revenue.

**Background information:** The Department of Revenue proposes to adopt use tax notification and compliance requirements for remote vendors similar to Oklahoma legislation passed in 2011.

With tremendous increases in online and remote sales, a number of states are reviewing their requirements for use tax reporting by remote vendors. This proposal is the least onerous of concepts, which seeks to impose some reporting requirements on remote vendors without a collection obligation. Other states require remote vendors to collect the use tax either through affiliate nexus or click through mechanisms. Both types of statutes continue to be subject to unresolved legal challenges. The recent injunction, granted by the U.S. District Court regarding Colorado's reporting requirements, makes this tax area more uncertain. Any legislative proposal in this area is only meant to augment Kentucky's current Streamline Sales Tax efforts. It does not compete with federal legislation proposals granting remote collection authority.

**Other states:** At least thirty-seven states either have considered or passed legislation pertaining to remote tax collection. Judicial action is at various levels of determination throughout the country. Missouri, Tennessee and Virginia have proposed legislation in this area over the past several years with none enacted. Oklahoma recently enacted legislation and is seeing some compliance and related revenue from online retailers. Those retailers are complying with posting requirements notifying Oklahoma customers of their use tax liabilities.

**Groups positively and negatively impacted:** Positively impacted - Kentucky Retail Federation, Kentucky merchants and Kentucky consumers who receive more timely notice of potential use tax liability. Negatively impacted - Direct Marketers Association.

**Revenue Score:** The fiscal estimate of this proposal is still under review but sales and use tax receipts could increase by nearly \$5 million annually.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	+	+	+

### Proposal # 93: Return to a balanced interest rate on taxes owed to and by the state

**Background information:** A 2008 law change amended the tax interest rate from being equal for assessments and refunds to being increased by two percent for assessments and reduced by two percent for refunds. For example, the 2012 tax interest rate was established at four percent. Due to the 2008 law change, the rate for assessments is six percent and the rate for refunds is two percent.

**Other states:** 11 states other than Kentucky have different interest rates for assessments and refunds.

**Groups positively and negatively impacted:** Positively impacted – taxpayers that receive assessments or are due a refund. Negatively impacted – the General Fund and Road Fund.

**Revenue Score:** An approximate revenue loss per year of \$8 million.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
+	+	-	-	+

## Proposal # 94: Add clarifying language in KRS 139.480(11) regarding farm machinery that specifies combine header trailers are exempt from sales tax

*Note:* This is a proposal from the Department of Revenue.

**Background information:** Clarifying language for the farm machinery exemption to specifically include combine header trailers will ensure that all implement dealers and farmers alike receive the same treatment. The Department has provided recent administrative rulings to indicate this type machinery is exempt; however, history on this topic indicates some confusion and need for statutory clarification.

**Other states:** All border states offer some type of farm machinery exemption from sales tax. The exemption language for Indiana, Tennessee and Missouri appear to exclude header trailers from their exemption provisions.

**Groups positively and negatively impacted:** The explicit change to the farm machinery exemption will make the treatment of combine header trailers transparent to all parties.

**Revenue Score:** Revenue neutral.

SCORE ON TAX REFORM PRINCIPLES				
Fairness	Competitiveness	Elasticity	Adequacy	Simplicity & Compliance
N	N	N	N	N

## **Proposal # 95: Repeal the school tax rate exclusion from sales tax calculation on “residential telecommunications service” found in KRS 139.470(9)**

**Background information:** This provision excluding application of sales tax on the portion of a residential phone bill that includes a charge for the utility gross receipts license tax (school tax) was enacted in 1979. At the same time, the general residential utilities exemption went into effect. The school tax is a gross receipts tax up to a maximum rate of 3% imposed upon the provision of utility services within school districts that have elected to levy the tax. The tax is imposed upon the business providing the utility services. If the business passes the tax on to the customer as a line item, this portion of the receipt collections is still part of gross receipts subject to the 6% sales tax per the definition of gross receipts in KRS 139.010(12)(a)2. Without this exemption language in KRS 139.470(9), the school tax portion of a residential phone bill would be subject to the 6% sales tax. Please note that all telecommunications services other than pay phone services are subject to the 6% Kentucky sales tax (KRS 139.200).

Effective January 1, 2011, the definition of sales price was amended in the Streamlined Sales and Use Tax Agreement (SSUTA) to clarify what types of taxes a state may exclude from sales price. This change was made to increase uniformity and simplicity at the request of the retail community and telecommunications industry. The amendment to the administrative definition of “sales price” and accompanying Rule 327.9 specify that states may exclude from sales price those taxes on a retail sale that are 1) separately stated on the invoice, bill of sale or similar document given to the purchaser, 2) imposed on the seller and 3) allowed but not required to be passed on to the customer. These requirements do not allow Kentucky to continue exempting the school tax only on residential phone bills. Kentucky has the option of expanding the exemption to apply to all billings for communications services which includes the school tax, but the SSUTA also requires that states be consistent across all similar taxes. Therefore, effecting this broader change would require the current sales price/gross receipts definition in KRS 139.010(12) to be amended to exclude not only the school tax but also state/local transient room taxes, local restaurant tourism taxes, alcoholic beverage taxes along with any other local or federal taxes that may get passed on to customers as a line item charge on a retail transaction. The options available to remain in compliance with the Streamlined Sales and Use Tax Agreement are a minor exemption rollback or a significant exemption expansion with a major fiscal impact.

**Other states:** The partial sales tax exemption for school tax on residential phone bills is unique to Kentucky. Of the 24 SSUTA states, there are 14 that apply sales tax to other state, local and federal taxes through their definition of sales price (KY, IN, OH and TN included). Six states exclude these taxes from the definition of sales price and four states have yet to resolve the issue in their jurisdictions.

**Groups positively and negatively impacted:** Positively impacted - rolling back the narrow exemption for the school tax on a residential phone bill is supported by the telecommunications industry. Several industry representatives acknowledge their systems cannot effectively track this partial exemption on a residential bill. Negatively impacted - residential landlines are declining in use and consumers are unlikely to notice minor changes to their monthly phone bill upon repeal.

**Revenue Score:** A repeal of the sales tax exclusion on the school tax portion of a residential phone bill should have a fiscal impact of less than \$500,000. Without an amendment to the sales price definition during the 2013 General Assembly, Kentucky will be found out of compliance with SSUTA thereby jeopardizing sales tax collections from SST vendors. In FY12 total collections were \$18 million, with \$10.4 million of that from voluntary sellers.

<b>SCORE ON TAX REFORM PRINCIPLES</b>
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<b>Fairness</b>	<b>Competitiveness</b>	<b>Elasticity</b>	<b>Adequacy</b>	<b>Simplicity &amp; Compliance</b>
N	N	+	+	+